2019–2020 EDITION

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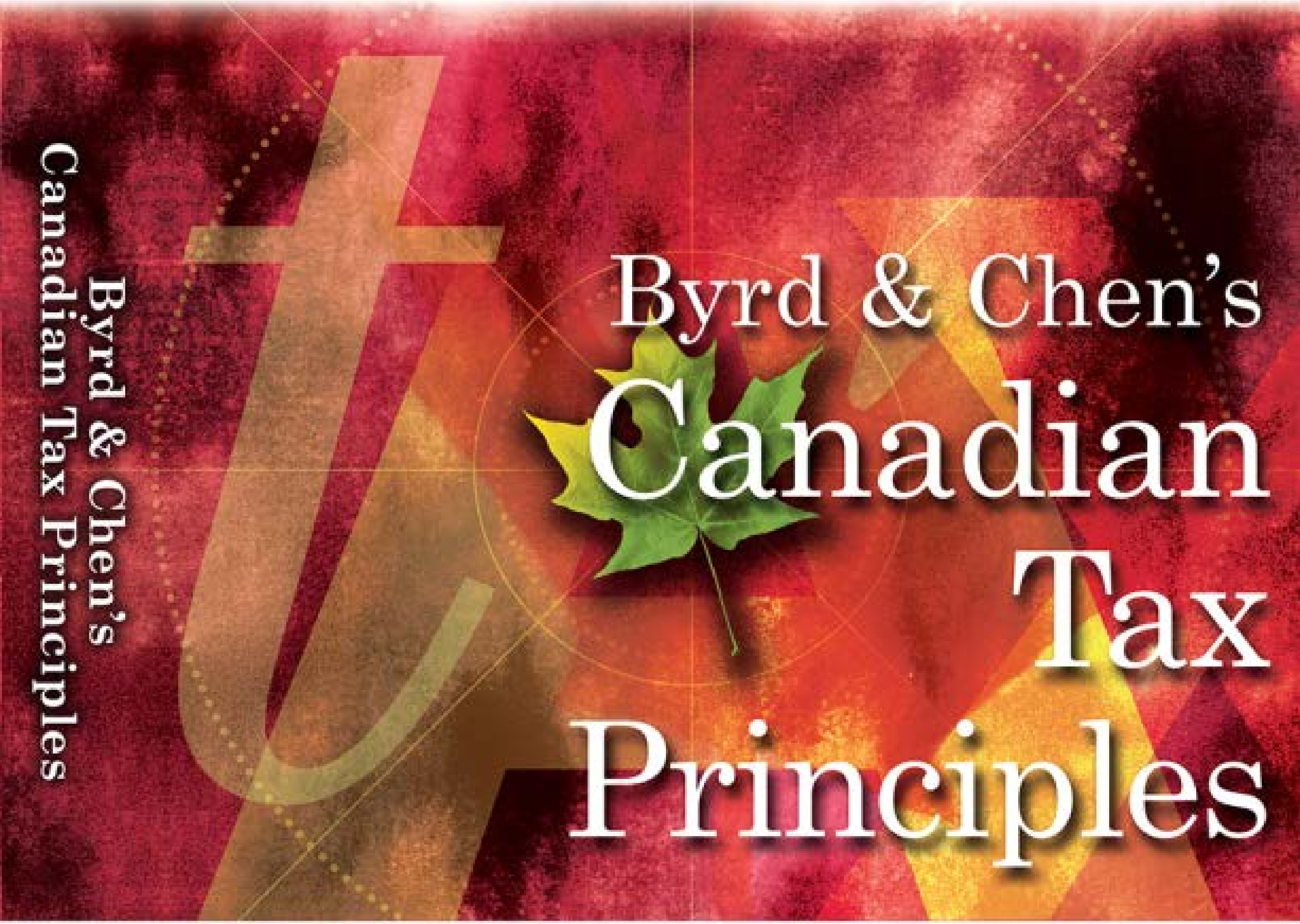


**Includes:** Volume I, Volume II, and Study Guide

# PREFACE

## Objectives Of The Canadian Tax Principles Package

### *Subject Coverage*

The objective of this text is to provide coverage of all the tax subjects that are taught in Canadian college and university tax courses. In so doing, it also provides comprehensive coverage of almost all the tax issues that are required in the educational programs of CPA Canada. The one area of these programs that is not covered is "Reporting Systems And Data Requirements For Tax Compliance".

This material is designed to be used in a two semester university or college course and is far too extensive to be completely covered in a single one semester course. The traditional split in the material would be to cover Chapters 1 through 11 in a first course dealing with the determination of Net Income For Tax Purposes for all taxpayers, as well as the calculation of Taxable Income and Tax Payable for individuals. This could be followed by a second course where the focus is primarily on the taxation of corporations. The relevant material on corporations is found in Chapters 12 through 17. The remaining Chapters 18 through 21 deal with partnerships, trusts, international taxation, and GST/HST.

### *Level Of Coverage*

In terms of style, we have attempted to strike a balance between the kind of complete documentation that can render the material incomprehensible to anyone other than a tax professional, and the total elimination of references that would make it impossible for readers to expand their understanding of particular points. In those situations where we feel the issue is sufficiently complex that further investigation could be helpful, we have provided a list of references to the relevant Sections of the *Income Tax Act* or other related materials. In contrast, no direction has been provided when the material is either very straightforward, or where the relevant parts of the *Act* would be obvious.

This book can be used with or without additional source material. Some instructors require students to acquire a copy of the *Income Tax Act* and permit its use as a reference during examinations. For instructors wishing to take this approach, frequent references to the *Act* have been included. For instructors not wishing to require the use of the *Income Tax Act*, we have designed the problem material so that students should be able to solve all of the included problems relying solely on the text as a reference.

### *The Need For Two Volumes*

In the over 30 years that we have been writing this text, we have seen the content grow from about 400 pages to more than 1,500 pages. We initially dealt with this increase in size by providing a separate Study Guide. However, the text alone has grown to over 1,000 pages and, while accommodating this in a single volume is feasible, the result would be far less useful to students than dividing the material into two reasonably sized volumes.

If there was any consensus among our users as to which subjects should be dealt with in each volume, they could be made available separately. However, virtually all of our users omit material from Volume I and include material from Volume II. Further, there is no consistent

pattern as to which material is omitted and which material is included. Given this, it would not be possible to produce separate volumes that meet the needs of all of our users.

### The Study Guide

The major objective of the Study Guide is to provide students with convenient access to the solutions for the Exercises and Self Study Problems. Having these solutions in a separate volume makes it much easier for students to simultaneously view the problem while solving it and then consult its complete and detailed solution.

The Study Guide also provides a number of additional features to enhance the learning experience. These can be described as follows:

- Detailed instructions on "How To Work Through" each Chapter in the text. This includes guidance on when to attempt Exercises and Self Study Problems as the student reads through the text.
- A detailed list of "Learning Objectives" for each Chapter. This allows the student to ensure that he/she has understood all of the relevant subjects covered in the Chapter.
- Sample tax returns for both individuals and corporations. These are useful practice for students using the ProFile tax software that is available with this text.
- At the end of each Chapter in the text, there is a list of key terms that were used in that Chapter. All of these terms are alphabetically listed in a Glossary that is at the back of the Study Guide. This provides an easy way to find the meaning of a term that was introduced in one Chapter, but is being referred to again in a subsequent Chapter.

# Problem Material Available

## For Students - Problems and Practice Exams With Solutions

The *Canadian Tax Principles* package contains a large number of problems with detailed solutions. See the **Online Student Supplements** section of this preface for more information about online access. The various types of problems and their location are as follows:

**Exercises** These are short problems that are focused on a single issue. Each Exercise is presented in the *Canadian Tax Principles* text, directly following the material that is relevant to its solution. This provides you with immediate feedback as to whether you have understood the material that you have just read. Solutions to the Exercises can be found in the Study Guide.

**Self Study Problems** These problems are more complex than the Exercises and include a number of comprehensive problems. Solutions to the Self Study Problems are included in the Study Guide while the problems are available online.

**Tax Software Self Study Problems** These problems are designed to be solved using the ProFile software that is available with *Canadian Tax Principles*. These problems are found in the Study Guide. The completed tax returns are available online.

**Supplementary Self Study Problems** Additional Self Study Problems, along with their detailed solutions, are available online for each chapter.

**Practice Examinations** A 90 minute practice examination and solution is available online for each chapter.

## For Instructors - Assignment Problems And Test Items

*Canadian Tax Principles* contains several types of problems designed for instructors:

**Assignment Problems** These problems vary in difficulty and include the most difficult non-comprehensive problems in the text. They are found at the end of each chapter of *Canadian Tax Principles*. They are sometimes adapted from professional examinations and may involve a number of different issues. Solutions to these

- **Practice Examinations** A 90-minute practice examination, along with a solution and suggested marking guide, is available for each chapter. These examinations contain a variety of problems, including multiple choice, essay questions and longer problems.
- **Power Point Presentations** There is a PowerPoint presentation for each chapter. These provide the basis for a quick review of the material covered in the chapter.
- **Glossary Flashcards** These flashcards help you test your understanding of the key terms used in each chapter.
- **2019 Tax Rates, Credits and Common CCA Classes** This is available as a PDF file, for reference. This tax information is also available at the front of Volumes 1 and 2, and CCA classes are available in the Chapter 5 Appendix.
- **Tax Returns** The Study Guide contains tax return examples and Self Study tax software problems, along with notes to their solutions. The completed tax returns are available on MyLab, to download and use with your ProFile software, or to view in PDF files.

# Instructor Supplements

In addition to all of the materials that are available to students, instructors will be provided with the following additional resources through the Pearson online catalogue:

- **Solutions Manual** A complete solutions manual is available to instructors. This manual includes detailed solutions to all of the Assignment Problems found in the textbook, including those that use the ProFile software. It also includes a problem concordance which correlates all problems from the last edition to this one. This is provided to assist instructors who have used the last edition with revising their courses.
- **Test Item File** For instructors adopting *Canadian Tax Principles*, a large and comprehensive selection of problems with detailed solutions for use on examinations is available (see previous description).

# Recent Changes

## Fall Economic Statement

Perhaps the most important change for 2019 was announced on November 21, 2018, when the Department Of Finance released the Accelerated Investment Incentive (AccII) provisions as part of its fall economic statement. These provisions remove the half-year reduction for most depreciable assets. In its place, there is a 50 percent addition to the base for calculating CCA on assets acquired during the year. This, in effect, triples the amount of CCA that can be deducted in the first year of a depreciable asset's life.

These provisions are discussed in detail in Chapter 5. However, the application of the AccII provisions required changes to material in almost every subsequent Chapter.

## The Federal Budget

### *Complications*

While the fall economic statement included what is, perhaps the most important change for 2019, most changes in legislation are introduced in the annual federal budget. This can greatly complicate the production of a comprehensive text that must be in bookstores the first week in September.

The first complication is that the date for each year’s budget is not entirely predictable. Between 2002 and 2019, the arrival date has ranged from December 10th of the preceding year (the 2002 budget) to May 2nd of the budget year (the 2006 budget). For 2019, the budget was presented on March 19, 2019.

The second potential complication is there is usually a considerable period of time between the budget statement and the release of the required legislation. This is further complicated in

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Also of great help in improving the text over the years were the comments and corrections provided by the following instructors:

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## *It's Our Fault*

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Clarence Byrd, Clarence Byrd Inc.
Ida Chen, Clarence Byrd Inc.
June, 2019

2019 by fact that there will be a fall election. If the Liberals do not maintain their majority in parliament, some or all of the provisions in the 2019 budget may never see the light of day. In preparing material based on the budget announcements, we have to recognize that some of the included material may not be appropriate if the proposed changes do not make it through parliament.

## *Previously Announced Measures*

There are several measures that were announced in previous budgets that are still working their way through the system in 2019. They can be described as follows:

**Small Business Deduction** In October, 2017, the government announced a phased in increase in the small business deduction. The applicable amounts are as follows:

| | |
|---|---|
| 2017 | 17.5% |
| 2018 | 18.0% |
| 2019 | 19.0% |

The increases in this deduction are reflected in lower rates on income eligible for the small business deduction. The federal rate on such income goes from 10.5 percent in 2017, to 10 percent in 2018, and to 9 percent in 2019.

**Non-Eligible Dividends** Non-eligible dividends are dividends that are paid out of income that is eligible for the small business deduction. The gross up and tax credit amounts that are applicable to these dividends are being altered to reflect the changes in the small business deduction. The phased in changes are as follows:

| | Gross Up (% Of Dividends) | Federal Credit (Fraction Of Gross Up) |
|---|---|---|
| 2017 | 17% | 21/29 |
| 2018 | 16% | 8/11 |
| 2019 | 15% | 9/13 |

**Income Sprinkling** Prior to 2018, the Tax On Split Income (TOSI) only applied to related minors. However, on December 13, 2017, the government released measures that extended this punitive tax measure to individuals of any age. The measures are effective for 2018 and subsequent taxation years. The goal of these measures was to make splitting income with related individuals significantly more difficult. These complex and complicated measures are likely to achieve this goal.

**Billed Basis Accounting** The 2017 budget indicated that the government will eliminate the use of the billed basis of revenue recognition that is currently permitted for some groups of professionals. The elimination of this provision is being phased in over a five year period at the rate of 20 percent in each year, starting in 2018.

**Passive Income Of CCPCs** The government has concluded that these companies have an unfair advantage in the accumulation of passive investments held within the corporation. This is because they retain more funds after the payment of the small amount of taxes applicable to income that is eligible for the small business deduction,

To make this situation less attractive, the 2018 Budget included legislation that would grind down the annual limit on the amount of income that is eligible for the small business deduction. Specifically, the $500,000 limit will be reduced on a straight-line basis for CCPCs having between $50,000 and $150,000 in investment income. This was accompanied by a number of other changes to the taxation of this income.

While this legislation was included in the 2018 Budget, it is only applicable to 2019 and subsequent years. Our coverage of these changes is found in Chapter 13.

# 2019 Rates, Credits And Other Data

For your convenience, this information, as well as the Chapter 5 Appendix of common CCA rates, is available **online** as a .PDF file.

## Information Applicable To Individuals

### *Federal Tax Rates For Individuals*

| Taxable Income In Excess Of | Federal Tax | Marginal Rate On Excess |
|---|---|---|
| $ -0- | $ -0- | 15.0% |
| 47,630 | 7,145 | 20.5% |
| 95,259 | 16,908 | 26.0% |
| 147,667 | 30,535 | 29.0% |
| 210,371 | 48,719 | 33.0% |

### *Federal Tax Credits For Individuals - Personal Credits (ITA 118)*

**Reference**

**118(1)(a)** **Married Persons** 15% of $12,069 ($1,810).

**118(1)(a)** **Spousal** 15% of $12,069 ($1,810), less 15% of the spouse's Net Income For Tax Purposes. Base amount increased by $2,230 (to $14,299) if the spouse is mentally or physically infirm. Not available when the spouse's income is more than $12,069 (or $14,299).

**118(1)(b)** **Eligible Dependant** 15% of $12,069 ($1,810), less 15% of the eligible dependant's Net Income For Tax Purposes. Base amount increased by $2,230 (to $14,299) if the eligible dependant is mentally or physically infirm. Not available when the eligible dependant's income is more than $12,069 (or $14,299).

**118(1)(b.1)** **Canada Caregiver For Child Under 18** 15% of $2,230 ($335).

**118(1)(c)** **Single Persons** 15% of $12,069 ($1,810).

**118(1)(d)** **Canada Caregiver** 15% of $7,140 ($1,071), reduced by 15% of the dependant's income in excess of $16,766.

**118(1)(e)** **Canada Caregiver - Additional Amount** If either the income adjusted infirm spousal credit base or the income adjusted infirm eligible dependant credit base is less than the spouse or eligible dependant's income adjusted credit base ($7,140, less the spouse or dependant's income in excess of $16,766), an additional Canada caregiver credit is available based on 15% of the deficiency.

**118(2)** **Age** 15% of $7,494 ($1,124). The base for this credit is reduced by the lesser of $7,494 and 15% of the individual's net income in excess of $37,790. Not available when income is more than $87,750. If the individual cannot use this credit, it can be transferred to a spouse or common-law partner.

**118(3)** **Pension** 15% of up to $2,000 of eligible pension income for a maximum credit of $300 [(15%)($2,000)]. If the individual cannot use this credit, it can be transferred to a spouse or common-law partner.

**118(10)** **Canada Employment Credit** 15% of up to $1,222. This produces a maximum credit of $183.

### 2019 Content

They March 19, 2019 budget contained a fairly large number of proposals that were of varying importance. The following lists describes most of these changes.

**Personal Tax Measures**

- A proposal to limit access to the 50 percent deduction on stock options (see Chapter 3). The limit would be based on the first $200,000 of the fair market value of the securities included in new grants. It is unlikely that these proposals will be implemented this year.
- Provisions designed to limit the ability of mutual funds to defer certain types of capital gains and to convert ordinary income into capital gains.
- A new Canada training credit that will become available in 2020 (see Chapter 4).
- An increase in the Home Buyers' Plan limit from $25,000 to $35,000 (see Chapter 10).
- A modification of the change in use rules for multi-unit residential properties (see Chapter 8).
- An expansion of the types of annuities that can be used by registered plans to fund retirement income (see Chapter 10).
- Changes to the rules for Registered Disability Savings Plans.
- Changes to the rules for kinship care providers.
- Removal of the requirement that donations of cultural property be of national importance in order to qualify for enhanced charitable donations treatment.
- Amended the legislation for the medical expense tax credit to reflect the new rules for cannabis regulation.
- Modification of the rules for determining pensionable service under an individual pension plan.
- New rules applicable to individuals carrying on a business in a tax free savings account.

**Business Tax Measures**

- New rules that provide for a 100 percent write off of zero emission vehicles in the year of acquisition (see Chapter 5).
- Removal of the income constraint for determining the amount of scientific research expenditures that are eligible for the enhanced 35 percent investment tax credit (see Chapter 14).
- Changes in the rules for determining the amount of farming and fishing income that is eligible for the small business deduction.
- Several provisions to enhance government support for Canadian journalism. These include:
    - a non-refundable tax credit for digital news subscriptions (see Chapter 4);
    - a refundable credit for salaries paid to newsroom employees (see Chapter 12); and
    - a provision that extends qualified donee status to registered journalism organizations.

We have provided coverage of some, but not all, of these changes as indicated by the Chapter references included in the list items.

# Acknowledgments

We would like to thank the many students who have used this book, the instructors who have adopted it at colleges and universities throughout Canada, as well as the assistants and tutors who have been involved in these courses.

In terms of the content of the book, we would like to give special thanks to:

**Gary Donell** After many years with the CRA, Gary is now affiliated with the Ottawa office of Welch LLP. Gary has been a significant contributor to this text for nearly 20

years, bringing to it an outstanding knowledge of income tax issues. He has made many valuable suggestions that have contributed greatly to the accuracy and clarity of the material. In addition, he was responsible for writing much of the Chapter 18 material on partnerships and the Chapter 20 material on international taxation. Mr. Donell has undertaken this work independently of his work with Welch LLP. The views that are contained in this publication do not, in any way, reflect the policies of Welch LLP.

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## Other Common Federal Personal Credits (Various ITA)

118.01 **Adoption Expenses Credit** 15% of eligible expenses (reduced by any reimbursements) up to a maximum of $16,255 per adoption. This results in a maximum credit of $2,438.

118.041 **Home Accessibility Credit** 15% of lesser of $10,000 and the amount of qualifying expenditures for the year.

118.05 **First Time Home Buyer's Credit** 15% of $5,000 ($750) of the cost of an eligible home.

118.06 **Volunteer Firefighters Credit** 15% of $3,000 ($450) for qualifying volunteers.

118.07 **Volunteer Search And Rescue Workers Credit** 15% of $3,000 ($450) for qualifying volunteers.

118.1 **Charitable Donations - Regular** The general limit on amounts for this credit is 75% of Net Income. There is an addition to this general limit equal to 25% of any taxable capital gains and 25% of any recapture of CCA resulting from a gift of capital property. In addition, the income inclusion on capital gains arising from a gift of some publicly traded shares is reduced from one-half to nil. For individuals, the credit is equal to:

[(15%)(A)] + [(33%)(B)] + [(29%)(C)] where:

A = The first $200 of eligible gifts.
B = The lesser of:
- Total gifts, less $200; and
- Taxable Income, less $210,371.

C = The excess, if any, by which the individual's total gifts exceed the sum of $200 plus the amount determined in B.

118.2 **Medical Expenses** The medical expense tax credit is determined by the following formula:

**[15%] [(B - C) + D]**, where:

**B** is the total of an individual's medical expenses for himself, his spouse or common-law partner, and any of his children who have not reached 18 years of age at the end of the year.
**C** is the lesser of 3% of the individual's Net Income For Tax Purposes and $2,352 (2019 figure).
**D** is the total of all amounts each of which is, in respect of a dependant of the individual (other than a child of the individual who has not attained the age of 18 years before the end of the taxation year), an amount determined by the formula:

**E - F**, where:

**E** is the total of the dependant's medical expenses
**F** is the lesser of 3% of the dependant's Net Income For Tax Purposes and $2,352 (2019 figure).

118.3 **Disability - All Ages** 15% of $8,416 ($1,262). If not used by the disabled individual, it can be transferred to a person claiming that individual as a dependant.

118.3 **Disability Supplement - Under 18 And Qualifies For The Disability Tax Credit** 15% of $4,909 ($736), reduced by the total of amounts paid for attendant care or supervision in excess of $2,875 that are deducted as child care costs, deducted as a disability support amount, or claimed as a medical expense in calculating the medical expense tax credit.

### Education Related Credits

118.5 • **Tuition Fees Which Includes Examination And Ancillary Fees**
- 15% of qualifying tuition fees
- 15% of examination fees for both post-secondary examinations and examinations required in a professional program
- 15% of ancillary fees that are imposed by a post-secondary educational institution on all of their full or part-time students. Up to $250 in such ancillary fees can be claimed even if not required of all students.

118.62 • **Interest On Student Loans**
15% of interest paid on qualifying student loans.

118.9 • **Transfer Of Tuition Credit**
If the individual cannot use the credit, is not claimed as a dependant by his spouse, and does not transfer the unused credit to a spouse or common-law partner, then a parent or grandparent of the individual can claim up to $750 [(15%)($5,000)] of any unused tuition credit. The amount that can be transferred is reduced by the amount of the credit claimed by the student for the year.

118.7 **Employment Insurance** 15% of amounts paid by employees up to the maximum Employment Insurance premium of $860 (1.62% of $53,100). This produces a maximum tax credit of $129 [(15%)($860)].

118.7 **Canada Pension Plan** 15% of amounts paid by employees up to the maximum Canada Pension Plan contribution of $2,749 [5.1% of ($57,400 less $3,500)]. This produces a maximum tax credit of $412 [(15%)($2,749)]. For self-employed individuals, the payment is $5,498 ($2,749 times 2).

122.51 **Refundable Medical Expense Supplement** The individual claiming this amount must be over 17 and have earned income of at least $3,645. The amount is equal to the lesser of $1,248 and 25/15 of the medical expense tax credit. The refundable amount is then reduced by 5% of family Net Income in excess of $27,639. Not available when family income is more than $52,599.

122.9 **Refundable Teacher And Early Childhood Educator School Supply Tax Credit** A maximum of 15% of up to $1,000 ($150) of eligible expenditures that are made by eligible educators.

127(3) **Political Donations** Three-quarters of the first $400, one-half of the next $350, one-third of the next $525, to a maximum credit of $650 on donations of $1,275.

127.4 **Labour Sponsored Venture Capital Corporations (LSVCC) Credit** The federal credit is equal to 15 percent of acquisitions of provincially registered LSVCCs.

ITA 82 and ITA 121 **Dividend Tax Credit**

- **Eligible Dividends** These dividends are grossed up by 38%. The federal dividend tax credit is equal to 6/11 of the gross up. The credit can also be calculated as 15.02% of the grossed up dividends, or 20.7272% of the actual dividends received.
- **Non-Eligible Dividends** These dividends are grossed up by 15%. The federal dividend tax credit is equal to 9/13 of the gross up. The credit can also be calculated as 9.0301% of the grossed up dividends, or 10.3846% of the actual dividends received.

## Other Data For Individuals

ITA 82 **Dividend Gross Up**

**Eligible Dividends** For these dividends, the gross up is 38% of dividends received.

**Non-Eligible Dividends** For these dividends, the gross up is 15% of dividends received.

Chapter 4 **OAS Clawback Limits** The tax (clawback) on Old Age Security (OAS) benefits is based on the lesser of 100% of OAS benefits received, and 15% of the amount by which "threshold income" (Net Income For Tax Purposes, calculated without the OAS clawback) exceeds $77,580.

Chapter 4 **EI Clawback Limits** The tax (clawback) on Employment Insurance (EI) benefits under the *Employment Insurance Act* is based on the lesser of 30% of the EI benefits received, and 30% of the amount by which "threshold income" exceeds $66,375 (1.25 times the maximum insurable earnings of $53,100). For this purpose, "threshold income" is Net Income For Tax Purposes, calculated without the OAS or EI clawbacks.

Chapter 9 **Child Care Expenses** The least of three amounts:

1. The amount actually paid for child care services. If the child is at a camp or boarding school, this amount is limited to a weekly amount $275 (any age if eligible for disability tax credit), $200 (under 7 year of age), or $125 (age 7 through 16 or over 16 with a mental or physical impairment).
2. The sum of the **Annual Child Care Expense Amounts** for the taxpayer's eligible children. The per child amounts are $11,000 (any age if eligible for disability tax credit), $8,000 (under 7 year of age), or $5,000 (age 7 through 16 or over 16 with a mental or physical impairment).
3. 2/3 of the taxpayer's **Earned Income** (for child care expenses purposes).

Chapter 10 **RRSP Deduction Room** For 2019, the addition to RRSP deduction room is equal to:

- the lesser of $26,500 and 18% of 2018 Earned Income,
- reduced by the 2018 Pension Adjustment and any 2018 Past Service Pension Adjustment,
- and increased by any 2018 Pension Adjustment Reversal.

Chapter 11 **Lifetime Capital Gains Deduction** For 2019, the deduction limit for dispositions of shares of qualified small business corporations is $866,912. There is an additional amount for farm or fishing properties of $133,088, providing a total of $1,000,000 for such properties.

**Provincial Tax Rates And Provincial Credits For Individuals** Provincial taxes are based on Taxable Income, with most provinces adopting multiple rates. The number of brackets range from three to five. Provincial tax credits are generally based on the minimum provincial rate applied to a credit base that is similar to that used for federal credits. In addition to regular rates, two provinces use surtaxes.

## Information Applicable To Individuals And Corporations

ITR 4301 **Prescribed Rate** The following figures show the base rate that would be used in calculations such as imputed interest on loans. It also shows the rates applicable on amounts owing to and from the CRA. For recent quarters, the interest rates were as follows:

| Year | Quarter | Base Rate | Owing From* | Owing To |
|---|---|---|---|---|
| 2017 | All | 1% | 3% | 5% |
| 2018 | I | 1% | 3% | 5% |
| 2018 | II to IV | 2% | 4% | 6% |
| **2019** | **I, II** | **2%** | **4%** | **6%** |

*The rate on refunds to corporations is limited to the base rate, without the additional 2%.

**Automobile Deduction Limits**

- CCA is limited to the first $30,000 of the automobiles cost, plus applicable GST/HST/PST (not including amounts that will be refunded through input tax credits).
- Interest on financing of automobiles is limited to $10 per day.
- Deductible leasing costs are limited to $800 per month (other constraints apply).
- Operating cost benefit = $0.28 per kilometre.
- Deductible rates = $0.58 for first 5,000 kilometres, $0.52 for additional kilometres.

**CCA Rates** See Appendix to Chapter 5.

**Quick Method Rates (GST Only)**

| | Percentage On GST Included Sales | |
|---|---|---|
| | First $30,000 | On Excess |
| Retailers And Wholesalers | 0.8% | 1.8% |
| Service Providers And Manufacturers | 2.6% | 3.6% |

**Note** Different rates apply in the provinces that have adopted an HST system.

## Information Applicable To Corporations

**Federal Corporate Tax Rates** are as follows (federal tax abatement removed):

| | |
|---|---|
| General Business (Before General Rate Reduction) | 28% |
| General Business (After General Rate Reduction Of 13%) | 15% |
| Income Eligible For M&P Deduction | 15% |
| Income Eligible For Small Business Deduction | 9% |
| Part IV Refundable Tax | 38-1/3% |
| Part I Refundable Tax On Investment Income Of CCPC (ART) | 10-2/3% |

Reference

89(1) **General Rate Income Pool** A CCPC's General Rate Income Pool (GRIP) is defined as follows:

- The GRIP balance at the end of the preceding year; plus
- 72% of the CCPC's Taxable Income after it has been reduced by amounts eligible for the small business deduction and aggregate investment income; plus
- 100% of eligible dividends received during the year; plus
- adjustments related to amalgamations and wind-ups; less
- eligible dividends paid during the preceding year.

125(1) **Small Business Deduction** is equal to 19% of the least of:

A. Net Canadian active business income.

B. Taxable Income, less:

1. 100/28 times the ITA 126(1) credit for taxes paid on foreign non-business income, calculated without consideration of the additional refundable tax under ITA 123.3 or the general rate reduction under ITA 123.4; and

2. 4 times the ITA 126(2) credit for taxes paid on foreign business income, calculated without consideration of the general rate reduction under ITA 123.4.

C. The annual business limit of $500,000, less any portion allocated to associated corporations, less the grinds for large corporations and passive income.

123.3 **Additional Refundable Tax On Investment Income (ART)** is equal to 10-2/3% of the lesser of:

- the corporation's "aggregate investment income" for the year [as defined in ITA 129(4)]; and
- the amount, if any, by which the corporation's Taxable Income for the year exceeds the amount that is eligible for the small business deduction.

123.4(2) **General Rate Reduction** is equal to 13% of Full Rate Taxable Income. This is Taxable Income, reduced by; income eligible for the small business deduction, income eligible for the M&P deduction and the corporation's "aggregate investment income" for the year.

125.1 **Manufacturing And Processing Deduction** is equal to 13% of the lesser of:

A. Manufacturing and processing profits, less amounts eligible for the small business deduction; and

B. Taxable Income, less the sum of:

1. the amount eligible for the small business deduction;
2. 4 times the foreign tax credit for business income calculated without consideration of the ITA 123.4 general rate reduction; and
3. "aggregate investment income" (of CCPCs) as defined in ITA 129(4).

126(1) **Foreign Tax Credits For Corporations** The Foreign Non-Business Income Tax Credit is the lesser of:

- The tax paid to the foreign government (for corporations, there is no 15% limit on the foreign non-business taxes paid); and
- An amount determined by the following formula:

$$\left[\frac{\text{Foreign Non-Business Income}}{\text{Adjusted Division B Income}}\right][\text{Tax Otherwise Payable}]$$

126(2) The Foreign Business Income Tax Credit is equal to the least of:

- The tax paid to the foreign government;
- An amount determined by the following formula:

$$\left[\frac{\text{Foreign Business Income}}{\text{Adjusted Division B Income}}\right][\text{Tax Otherwise Payable}];\ \text{and}$$

- Tax Otherwise Payable for the year, less any foreign tax credit taken on non-business income under ITA 126(1).

129(4) **Refundable Portion Of Part I Tax Payable** is defined as the least of three items:

**1.** the amount determined by the formula

A - B, where

A is 30-2/3% of the corporation's aggregate investment income for the year, and

B is the amount, if any, by which the foreign non-business income tax credit exceeds 8% of its foreign investment income for the year.

**2.** 30-2/3% of the amount, if any, by which the corporation's taxable income for the year exceeds the total of:

- the amount eligible for the small business deduction;
- 100 ÷ 38-2/3 of the tax credit for foreign non-business income; and
- 4 times the tax credit for foreign business income.

**3.** the corporation's tax for the year payable under Part I.

129(4) **Aggregate Investment Income** is the sum of:

- net taxable capital gains for the year, reduced by any net capital loss carry overs deducted during the year; and
- income from property including interest, rents, and royalties, but excluding dividends that are deductible in computing Taxable Income. Since foreign dividends are generally not deductible, they would be included in aggregate investment income.

129(4) **ELIGIBLE 2019 Refundable Dividend Tax On Hand** (RDTOH) is defined as follows:

**Beginning Balance** The transitional January 1, 2019 Eligible RDTOH balance which is the lesser of:

- The January 1, 2019 single RDTOH balance; and
- 38-1/3 percent of the January 1, 2019 GRIP balance

**Additions**

- Part IV taxes paid on eligible dividends from non-connected taxable Canadian corporations. These are commonly referred to as portfolio dividends.
- Part IV taxes paid on eligible dividends from connected corporations to the extent that such dividends included a refund from the paying corporation's Eligible RDTOH.

**Deduction** Deducted from this total would be any dividend refund claimed from the Eligible RDTOH account in the previous taxation year. For 2019, this deduction is reflected in the transitional RDTOH balance and will not be deducted again.

**NON-ELIGIBLE 2019 Refundable Dividend Tax On Hand** (RDTOH) is defined as follows:

**Beginning Balance** The transitional January 1, 2019 Non-Eligible RDTOH balance is equal to the excess, if any, of the January 1, 2019 balance in the single RDTOH account, over 38-1/3 percent of the January 1, 2019 GRIP balance.

**Additions** There are three items that are added to the Non-Eligible RDTOH beginning balance:

- All of the Part I refundable tax for the year.
- Part IV taxes paid on non-eligible dividends from connected corporations to the extent that such dividends included a refund from the paying corporation's Non-Eligible RDTOH.
- Part IV taxes paid on non-eligible dividends from non-connected taxable Canadian corporations.

**Deduction** Deducted from this total would be any dividend refund claimed from the Non-Eligible RDTOH account in the previous taxation year. For 2019, this deduction is reflected in the transitional RDTOH and will not be deducted again.

186(1) **Part IV Tax** is assessed at a rate of 38-1/3% of portfolio dividends, plus dividends received from a connected company that gave rise to a dividend refund for the connected company as a result of the payment.

# Tax Related Web Sites

### *GOVERNMENT*

**Canada Revenue Agency** www.canada.ca/en/revenue-agency
**Department of Finance Canada** www.fin.gc.ca

### *CPA FIRMS*

**BDO** www.bdo.ca/en-ca/services/tax/domestic-tax-services/overview/
**Deloitte.** www2.deloitte.com/ca/en/pages/tax/topics/tax.html
**Ernst & Young** www.ey.com/CA/en/Services/Tax
**KPMG** www.kpmg.com/ca/en/services/tax
**PricewaterhouseCoopers** www.pwc.com/ca/en/tax/publications.jhtml

### *OTHER*

**CPA Canada** www.CPAcanada.ca
**Canadian Tax Foundation** www.ctf.ca
**ProFile Tax Suite** www.profile.intuit.ca

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# CHAPTER 2

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# CHAPTER 4

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(Continued)

# Chapter 4 - Continued



# CHAPTER 5

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# CHAPTER 7

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# CHAPTER 9

## Other Income, Other Deductions, And Other Issues

# CHAPTER 10

## Retirement Savings And Other Special Income Arrangements



# Study Guide

Your two volume textbook is accompanied by a separate Study Guide that is available in print and online.

The chapters of this Study Guide correspond to the chapters of ***Byrd & Chen's Canadian Tax Principles.***

Each of these Study Guide chapters contains the following:

- Detailed guidance on how to work through the text and problems in the chapter.
- Detailed solutions to the Exercises and Self Study Problems in the textbook for the chapter.
- A list of learning objectives for the material in the chapter.

In addition, the Study Guide contains:

- Two sample personal tax returns and two Self Study Tax Software Problems in Chapters 4 and 11.
- A sample corporate tax return in Chapter 13.
- An extensive Glossary.

# CHAPTER 1

# Introduction To Federal Taxation In Canada

## The Canadian Tax System

### Alternative Tax Bases

1-1. There are a variety of ways in which taxes can be classified. One possible basis of classification would be the economic feature or event that is to be taxed. Such features or events are referred to as the base for taxation and a large number of different bases are used in different tax systems throughout the world. Some of the more common tax bases are as follows:

**Income Tax** A tax on the income of certain defined entities.

**Property Tax** A tax on the ownership of some particular set of goods.

**Consumption Tax** A tax levied on the consumption or use of a good or service. Also referred to as sales tax or commodity tax.

**Value Added Tax** A tax levied on the increase in value of a good or service that has been created by the taxpayer's stage of the production or distribution cycle.

**Tariffs or Customs Duties** A tax imposed on the importation or exportation of certain goods or services.

**Transfer Tax** A tax on the transfer of property from one owner to another.

**User Tax** A tax levied on the user of some facility such as a road or airport.

**Capital Tax** A tax on the invested capital of a corporation.

**Head Tax** A tax on the very existence of some classified group of individuals.

1-2. At one time or another, some level of Canadian government has used, or is still using, all of these bases for taxation. For example, the Canadian federal government currently has, in addition to income taxes on corporations, individuals, and trusts, such taxes as the Goods and Services Tax (GST), an alcoholic beverages tax, special transaction taxes, a gasoline tax, as well as others. The revenue figures for the major types of Canadian taxation can be found in Figure 1-1 (following page). The amounts that we have presented here are from the federal budget that was tabled on March 19, 2019.

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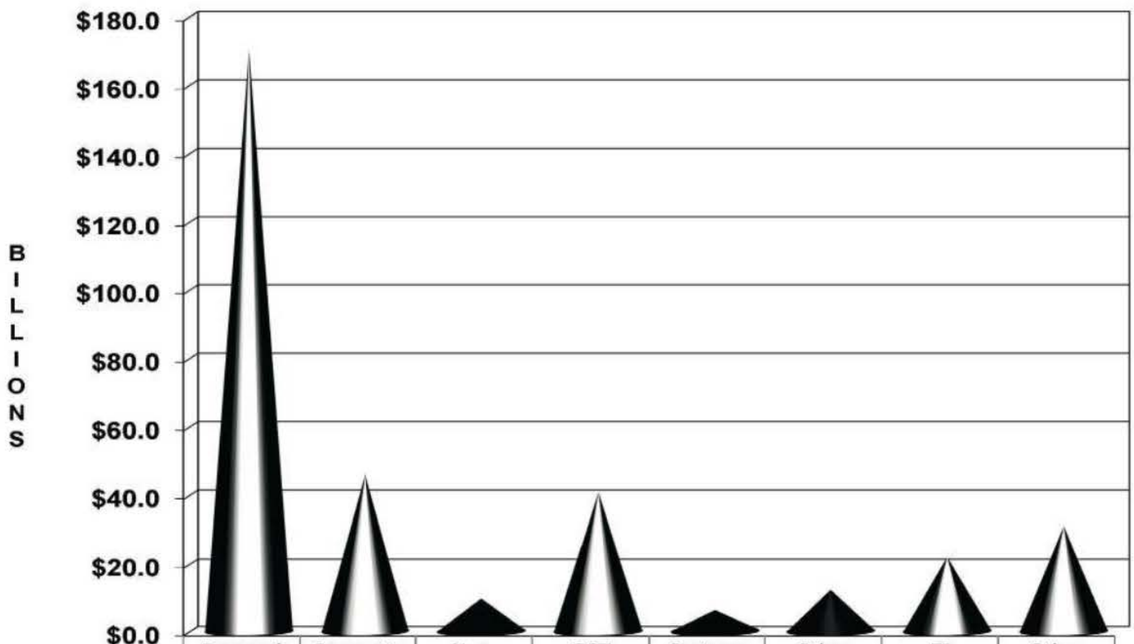
**Figure 1 - 1 Federal Government Revenues**

**2019 - 2020 Fiscal Year Total = $388.8 Billion**




| | Personal Income Tax (50.3%) | Corporate Income Tax (13.7%) | Non-Resident Income Tax (2.9%) | GST (12.0%) | Customs Import Duties (1.9%) | Other Excise Taxes (3.6%) | EI Premiums (6.5%) | Other Revenues (9.1%) |
|---|---|---|---|---|---|---|---|---|
| ■ Billions | $170.4 | $46.3 | $9.7 | $40.8 | $6.3 | $12.3 | $22.0 | $31.0 |

1-3. Figure 1-1 makes it very clear that the dominant form of Canadian taxation at the federal level is the income tax that is levied on individuals. More than 50 percent of federal revenues come from this source.

1-4. Running a distant second is income taxes on Canadian corporations at 13.7 percent of federal revenues, closely followed by GST collections at 12 percent. These two sources have been moving closer together as GST collections have become a more important source.

1-5. Employment insurance revenues at 6.5 percent of the total are also important. Taken together, non-resident revenues, customs duties, and excise taxes, provide 8.4 percent of the total.

1-6. Other revenues consist of revenues from Crown corporations, fuel charges, other programs, and net foreign exchange.

## Taxable Entities In Canada

### *Federal Income Tax*

1-7. Three types of entities are subject to federal income taxation. These are:

- Individuals (human beings)
- Corporations
- Trusts

1-8. You should note that the *Income Tax Act* uses the term "person" to refer to all three types of taxable entities. This can be a bit confusing in that the dictionary defines person as "a human being, whether man, woman, or child". Despite this conventional usage of the term person, the *Income Tax Act* applies it to both corporations and trusts. When the *Act* wishes to refer to a human taxpayer, it uses the term "individual".

1-9. For income tax purposes, unincorporated businesses such as partnerships and proprietorships are not viewed as taxable entities. Rather, income earned by an unincorporated business organization is taxed in the hands of the proprietor (who would be an individual) or the partner. Note that members of a partnership may be individuals, trusts, or corporations.

1-10. As discussed in Chapter 2, "Procedures And Administration", all three types of taxable entities are required to file income tax returns. The return for an individual is referred to as a T1, for a corporation, a T2, and for a trust, a T3. Proprietorships and partnerships do not file income tax returns as they are not taxable entities.

### GST

1-11. The requirement to register to collect and remit GST generally extends to any person engaged in commercial activity in Canada. You should note that the definition of a person for GST purposes is different from that used in the *Income Tax Act*. For income tax purposes, a "person" is restricted to an individual, a corporation, or a trust. Unincorporated businesses do not file separate income tax returns.

1-12. Under GST legislation, the concept of a person is much broader, including individuals, partnerships, corporations, estates of deceased individuals, trusts, charities, societies, unions, clubs, associations, commissions, and other organizations. Chapter 21, "GST/HST" includes detailed coverage of the Goods And Services Tax and the Harmonized Sales Tax.

## Exercise One - 1

**Subject:** Taxable Entities For Income Tax Purposes

Which of the following entities could be required to file an income tax return?

- Max Jordan (an individual)
- Jordan's Hardware Store (an unincorporated business)
- Jordan & Jordan (a partnership)
- The Jordan family trust (a trust)
- Jordan Enterprises Ltd. (a corporation)
- The Jordan Foundation (an unincorporated charity)

## Exercise One - 2

**Subject:** Taxable Entities For GST Purposes

Which of the following entities could be required to file a GST return?

- Max Jordan (an individual)
- Jordan's Hardware Store (an unincorporated business)
- Jordan & Jordan (a partnership)
- The Jordan family trust (a trust)
- Jordan Enterprises Ltd. (a corporation)
- The Jordan Foundation (an unincorporated charity

**SOLUTIONS available in print and online Study Guide.**

## Federal Taxation And The Provinces

### Personal Income Taxes

1-13. Under the Constitution Act, the federal, provincial, and territorial governments have the power to impose taxes. The provinces and territories are limited to direct taxation as delegated in the Act, a constraint that leaves all residual taxation powers to the federal government. The provinces are further limited to the taxation of income earned in the particular province and the income of persons resident in that province. Within these limitations, all of the provinces and territories impose both personal and corporate income taxes.

1-14. Under the federal/provincial tax collection agreement, provincial taxes are calculated by applying a provincial tax rate to a Taxable Income figure. With the exception of Quebec, all of the provinces use the same Taxable Income figure that is used at the federal level.

1-15. Despite the use of the federal Taxable Income figure, the provinces have retained considerable flexibility in their individual tax systems. This flexibility is achieved in two ways:

- Each province can apply different rates and surtaxes to as many tax brackets as it wishes.
- More importantly, each province is able to set different provincial credits to apply against provincial Tax Payable. While most provinces have provincial credits that are similar to credits that are established at the federal level, the value of these credits varies considerably at the provincial level. For example, the 2019 base for the basic personal tax credit varies from $8,481 in Nova Scotia to $19,639 in Alberta. In addition, many provinces have additional types of credits. As an example of this, Nova Scotia and Prince Edward Island have a credit for dependent children under 6 years of age.

1-16. The provincial differences complicate the preparation of tax returns. The level of complication varies from province to province, depending on the degree to which provincial tax brackets and provincial tax credits resemble those applicable at the federal level.

1-17. Because of these complications, the problem material in this text will, in general, not require the calculation of provincial taxes for individuals. However, because the combined federal/provincial rate is important in many tax-based decisions (e.g., selecting between alternative investments), we will continue to refer to overall combined rates, despite the fact that such figures are very specific to the province in which the income is taxed, as well as the characteristics associated with the individual filing the return.

#### Exercise One - 3

**Subject:** Federal And Provincial Taxes Payable

John Forsyth has Taxable Income of $27,000. For the current year, his federal tax rate is 15 percent, while the corresponding provincial rate is 7.5 percent. Determine Mr. Forsyth's combined federal and provincial tax payable, before consideration of any available credits against Tax Payable.

**SOLUTION available in print and online Study Guide.**

### Corporate Income Taxes

1-18. The system used to calculate provincial corporate income tax payable is similar to the system that is applicable to individuals. Provincial corporate income tax is levied on Taxable Income. All of the provinces, with the exception of Alberta and Quebec, use the federal *Income Tax Act* to compute Taxable Income. Even in Alberta and Quebec, the respective provincial Tax Acts have many of the same features as the federal *Act*.

1-19. With respect to the collection of corporate income taxes, only Alberta and Quebec collect their own corporate income taxes. In all other provinces and territories, corporate income taxes are collected by the federal government on behalf of the provinces.

### *GST, HST And PST*

1-20. Although detailed coverage of GST and HST can be found in Chapter 21, GST/HST, we will provide a short overview here as part of our introduction to federal taxation. When the federal government proposed a joint federal/provincial goods and services tax (GST) in 1987, the lack of interest by provincial governments meant that the GST was introduced only at the federal level. Provincial sales taxes remained in place without significant alteration. As a result, two different sales taxes were collected, accounted for, and remitted.

1-21. This situation was very costly and time consuming for businesses operating in more than one province, as they had to file multiple sales tax returns under different sets of rules. This was clearly an inefficient way to generate tax revenues and, not surprisingly, considerable pressure developed for the harmonization of the separate federal and provincial sales taxes.

1-22. Despite the obvious efficiencies that would result from harmonization, it has not been accepted across Canada. Quebec administers its own Quebec sales tax (QST) which is a somewhat harmonized system. While its coverage is similar to the GST, it is not identical.

1-23. In several provinces there is a harmonized sales tax (HST) which is, in effect, a combined federal/provincial sales tax. These systems differ from the Quebec model in that the HST is a single tax administered by the federal government. The HST provinces are New Brunswick, Nova Scotia, Newfoundland, Prince Edward Island and Ontario.

1-24. Since each HST province chooses the rate for the provincial portion of the HST and the provinces have selected different rates, the HST is not a single rate throughout the HST provinces. As a result, even among the HST provinces, the application of the HST on a sale can result in a sales tax figure that varies depending on the province of sale.

1-25. The various provincial sales tax regimes have left Canada with a fragmented sales tax system. As of July 1, 2019, the different sales tax rates in the provinces are:

- GST Only
  - **5%** for Alberta
- HST Rates (Includes 5 Percent GST)
  - **13%** (5% + 8%) for Ontario
  - **15%** (5% + 10%) for New Brunswick, Newfoundland, Nova Scotia, and Prince Edward Island
- GST Plus Provincial Sales Tax
  - **11%** (5% + 6%) for Saskatchewan
  - **12%** (5% + 7%) for British Columbia
  - **12%** (5% + 7% as of July 1, 2019) for Manitoba
  - **14.975%** (5% + 9.975%) for Quebec

# Tax Policy Concepts

## Taxation And Economic Policy

1-26. The traditional goal of tax legislation has been to generate revenues for the relevant taxing authority. However, it is clear that today's approach to tax legislation is multi-faceted. We use tax legislation as a tool to facilitate a number of economic policy objectives:

> **Resource Allocation** Tax revenues are used to provide public goods and services. Pure public goods such as the cost of our national defense system are thought to benefit all taxpayers. As it is not possible to allocate costs to individuals on the basis of benefits received, such costs must be supported with general tax revenues. Similar allocations occur with such widely used public goods as education, health care, and pollution control. In some cases, the tax system also has an influence on the allocation

of private goods. For example, excise taxes are used to discourage the consumption of alcohol and tobacco products.

**Distribution Effects** Our tax system is used to redistribute income and wealth among taxpayers. Such provisions as the federal GST tax credit and provincial sales tax exemptions on food and low priced clothing have the effect of taking taxes paid by higher income taxpayers and distributing them to lower income wage earners or taxpayers with higher basic living costs in proportion to their income.

**Stabilization Effects** Taxes may also be used to achieve macroeconomic objectives. At various times, tax policy has been used to encourage economic expansion, increase employment, and to assist in holding inflation in check. An example of this is the emphasis on stimulating the economy that is found in recent budgets.

**Fiscal Federalism** This term refers to the various procedures that are used to allocate resources among different levels of government. For 2019 - 2020, it is estimated that transfers to other levels of government will amount to $76.9 billion. This compares to transfers to persons of $100.4 billion and $152.1 billion in direct spending.

## Taxation And Income Levels

### *General Approaches*

1-27. Policy makers are concerned about the relationship between income levels and rates of taxation. Taxes can be proportional, in that a constant rate is applied at all levels of income. In theory, this is our general approach to taxing the income of corporations. For public companies, the system is based on a flat rate that is applicable to all income earned by the company. However, a wide variety of provisions act to modify the application of this rate, resulting in a situation where many Canadian companies are not subject to this notional flat rate.

1-28. As an alternative, taxation can be regressive, resulting in lower effective rates of taxation as higher income levels are reached. Sales taxes generally fall into this regressive category as lower income individuals spend a larger portion of their total income and, as a consequence, pay a greater portion of their total income as sales taxes levied on their expenditures.

**EXAMPLE** Consider the Werner sisters:

Gertrude Werner has income of $200,000 and spends $40,000 of this amount. She lives in a province with a 13 percent harmonized sales tax (HST) on expenditures, resulting in the payment of $5,200 in HST. This represents a 2.6 percent effective tax rate on her $200,000 income.

Ingrid Werner has income of $40,000 and spends all of this amount. She lives in the same province as her sister, resulting in the payment of $5,200 in HST. This represents a 13 percent effective tax rate on her $40,000 income.

### Exercise One - 4

**Subject:** Regressive Taxes

Margie Jones has Taxable Income for the current year of $895,000, of which $172,000 is spent on goods and services that are subject to Harmonized Sales Tax (HST) at a rate of 13 percent. Her sister, Jane Jones, is a part-time student living in the same province and has Taxable Income of $18,000. During the current year, as a result of using some of her savings, she spends $27,500 on goods and services that are all subject to HST. Determine the effective sales tax rate as a percentage of the income of the two sisters.

**SOLUTION available in print and online Study Guide.**

**We suggest you work Self Study Problem One-1 at this point.**

1-29. In contrast to the regressive nature of sales taxes, the present system of personal income taxation is designed to be progressive, since higher rates are applied to higher levels of income. For 2019, the federal rates range from a low of 15 percent on the first $47,630 of Taxable Income to a high of 33 percent on Taxable Income in excess of $210,371.

### Progressive Vs. Regressive

1-30. As noted in the preceding paragraph, the federal income tax system taxes individuals using a progressive system. The major arguments in favour of this approach can be described as follows:

**Equity** Higher income individuals have a greater ability to pay taxes. As their income is above their basic consumption needs, the relative cost to the individual of having a portion of this income taxed away is less than the relative cost to lower income individuals, where additional taxation removes funds required for such essentials as food and housing.

**Stability** Progressive tax rates help maintain after-tax income stability by shifting people to lower tax brackets in times of economic downturn and to higher brackets when there is economic expansion. The resulting decreases or increases in income taxes serve to cushion the economic swings.

1-31. There are, however, a number of problems that can be associated with progressive rates. These can be briefly described as follows:

**Complexity** With progressive rates in place, efforts will be made to divide income among as many individuals (usually family members) as possible. These efforts to make maximum use of the lower tax brackets necessitate the use of complex anti-avoidance rules by taxation authorities.

**Income Fluctuations** In the absence of relieving provisions, progressive rates discriminate against individuals with highly variable income streams. That is, under a progressive system, an individual with $1,000,000 in income in one year and no income for the next three years will pay substantially more in taxes than an individual with the same $1,000,000 total earned over four years at a rate of $250,000 per year.

**Family Unit Problems** Progressive tax rates discriminate against single income family units. A family unit in which one spouse makes $200,000 and the other has no Taxable Income would pay significantly more in taxes than would be the case if each spouse earned $100,000.

**Economic Growth** It is clear that the high tax brackets that can be associated with a progressive system can discourage both employment and investment efforts. This could serve to limit economic growth.

**Tax Concessions** The high brackets associated with progressive systems lead to pressure for various types of tax concessions to be made available. Because high income individuals have a greater ability to take advantage of favourable provisions in the income tax legislation, they may actually wind up paying taxes at lower effective rates. In response to the possibility that, in extreme cases, some high income individuals pay no income taxes at all, there is an alternative minimum income tax that is imposed on certain taxpayers (see Chapter 11).

**Tax Avoidance And Evasion** Progressive rates discourage income reporting and encourage the creation of various means to evade taxation. Evasion strategies range from simple bartering, to cash only transactions, to offshore tax havens and finally to criminal activities.

**Reduced Tax Revenues** There is evidence that, if tax rates are too high, the result may be reduced aggregate tax revenues. Some authorities believe that this begins to occur at tax rates between 40 and 50 percent.

We would note that, with the maximum federal rate at 33 percent, the maximum combined federal/provincial rate in most provinces exceeds 50 percent, going as high as 54 percent in some Provinces for income in excess of $210,371. While it is difficult to determine the degree to which this will encourage tax evasion, it is almost certain that maximum tax rates at this level has and will be a major factor in decisions involving significant amounts of income being moved out of Canada. Individuals with income well in excess of the maximum threshold often have great flexibility in where they reside and where they invest.

Of particular importance is the possibility of moving to the U.S., particularly with the rates established under President Trump's tax reform. In several states, including Florida, there is no state income tax. This means that income is only taxed at the federal level. For an individual with income of $210,371, the applicable rate is only 35 percent. The rate reaches a maximum of 37 percent only when the individual's income exceeds $500,000. Given this 17 point spread (54% - 37%), it is likely that many high income individuals will at least consider a change in venue.

### Flat Tax Systems

1-32. While progressive tax systems continue to be pervasive, there has been a worldwide trend towards flattening rate schedules. One of the reasons for this trend is the fact that effective tax rates are not as progressive as the rate schedules indicate. As mentioned in the preceding paragraph, high bracket taxpayers tend to have better access to various types of tax concessions which can significantly reduce the effective rates for these individuals.

1-33. Given this situation, it has been suggested that we could achieve results similar to those which, in fact, prevail under the current system by applying a single or flat rate of tax to a broadened taxation base. In this context, the term base broadening refers to the elimination of tax concessions, resulting in tax rates that are applied to a larger income figure.

1-34. There is currently no flat provincial tax system in place in Canada. Alberta's 10 percent rate on the income of individuals was in place until 2015. However, faced with the financial difficulties generated by falling oil prices, the Alberta government introduced a progressive system in 2016.

**We suggest you work Self Study Problem One-2 at this point.**

## Tax Incidence

1-35. Tax incidence refers to the issue of who really pays a particular tax. While statutory incidence refers to the initial legal liability for tax payment, the actual economic burden may be passed on to a different group. For example, certain taxes on production might be the legal liability of the producer. However, they may be partly or entirely shifted to consumers through price increases on the goods produced.

1-36. Policy makers must be concerned with this to ensure that the system is working as intended. It is generally assumed that the incidence of personal income tax falls on individuals. In addition, in their role as consumers, individuals also assume the responsibility for a large portion of the various sales taxes that are levied in Canada. The incidence of corporate taxes is more open to speculation. Shareholders may bear the burden of corporate taxes in the short run. However, most authorities believe that, in the long run, this burden is shared by employees and consumers.

## Tax Expenditures

1-37. In contrast to government funding programs that provide payments to various entities in the economy, tax expenditures reflect revenues that have been given up by the government through the use of tax preferences, concessions, and other tax breaks. These expenditures may favour selected individuals or groups (senior citizens), certain kinds of income (capital gains), or certain characteristics of some taxpayers (the disabled).

1-38. In an effort to quantify the importance of these expenditures, the Department of Finance produces the publication, "Tax Expenditures And Evaluations" each year. The 2018 edition contains figures for the years 2012 through 2019 (projected). Examples of the 2012 estimates and 2019 projections of the cost of some of these expenditures include:

| Tax Expenditure | 2012 | 2019 |
|---|---|---|
| Charitable donations tax credit | $2,365 million | $2,885 million |
| Tax credit for spouse | $1,635 million | $1,840 million |
| Partial inclusion of capital gains | $3,330 million | $7,080 million |
| The deduction of RRSP contributions | $12,325 million | $18,270 million |
| Tax free gains on principal residences | $3,900 million | $6,090 million |

1-39. It is clear that such tax expenditures are of considerable significance in the management of federal finances. It is equally clear that the provision of this type of government benefit has become entrenched in our tax system. This situation can be explained by a number of factors:

- It is less costly to administer tax expenditures than it is to administer government funding programs.
- More decisions are left to the private sector so that funds may be allocated more efficiently.
- Tax expenditures reduce the visibility of certain government actions. This is particularly beneficial if some social stigma is attached to the programs. For example, a child tax benefit system is more acceptable than increasing social assistance (welfare) payments.
- Tax expenditures reduce the progressivity of the tax system. As many of the tax expenditures, such as tax shelters, are more available to higher income taxpayers, they serve to reduce effective tax rates in the higher rate brackets.

1-40. Tax expenditures are not only very substantial, they are also difficult to control. This was expressed several years ago by a former auditor general, as follows:

> A cost conscious Parliament is in the position of a team of engineers trying to design a more fuel efficient automobile. They think they have succeeded, but the engine seems to go on consuming as much gas as it did before. They cannot understand the problem until they notice that, hidden from view, a myriad of small holes have been punched through the bottom of the gas tank. This is too often the way of tax expenditures. Revenue leaks away, and MPs do not know about it until it is too late.

## Qualitative Characteristics Of Tax Systems

### *General Concepts*

1-41. Accounting standard setting bodies have established such concepts as relevance and reliability as being desirable qualitative characteristics of accounting information. While not established with the same degree of formality, it is clear that there are similar concepts that can be used to evaluate tax systems. Some of these desirable qualitative characteristics can be described as follows:

**Equity Or Fairness** Horizontal equity entails assessing similar levels of taxation for people in similar economic circumstances. If two individuals each have Taxable Income of $50,000, horizontal equity would require that they each pay the same amount of taxes.

In contrast, vertical equity means dissimilar tax treatment of people in different circumstances. If an individual has Taxable Income of $100,000, he should pay more taxes than an individual with Taxable Income of $50,000.

**Neutrality** The concept of neutrality calls for a tax system that interferes as little as possible with decision making. An overriding economic assumption is that decisions are always made to maximize the use of resources. This may not be achieved when tax factors affect how taxpayers save, invest, or consume. Taxes, by influencing economic decisions, may cause a less than optimal allocation of resources.

**Adequacy** A good tax system should meet the funding requirements of the taxing authority. It is also desirable that these revenues be produced in a fashion that is dependable and relatively predictable from year to year.

**Elasticity** Tax revenues should be capable of being adjusted to meet changes in economic conditions, without necessitating tax rate changes.

**Flexibility** This refers to the ease with which the tax system can be adjusted to meet changing economic or social conditions.

**Simplicity And Ease Of Compliance** A good tax system is easy to comply with and does not present significant administrative problems for the people enforcing the system.

**Certainty** Individual taxpayers should know how much tax they have to pay, the basis for payments, and the due date. Such certainty also helps taxing authorities estimate tax revenues and facilitates forecasting of budgetary expenditures.

**Balance Between Sectors** A good tax system should not be overly reliant on either corporate or individual taxation. Attention should also be given to balance within these sectors, insuring that no type of business or type of individual is asked to assume a disproportionate share of the tax burden.

**International Competitiveness** If a country's tax system has rates that are out of line with those in comparable countries, the result will be an outflow of both business and skilled individuals to those countries that have more favourable tax rates.

### *Conflicts Among Characteristics*

1-42. In designing a tax system, many compromises are required. Examples include the fact that flexibility is often in conflict with certainty, equity requires trade-offs in simplicity and neutrality, and some taxes with very positive objectives are very non-neutral in nature. An example of this last conflict is that the rates available to small businesses are very favourable because the government believes that this attracts investment to this sector, thereby encouraging employment and the development of active business efforts. However, this may not result in the optimal allocation of resources to the business sector as a whole.

### *Evaluation Of The Canadian System*

1-43. Canadian policy makers often refer to the preceding qualitative characteristics in discussions involving taxation policies. This would make it appropriate to consider how the current system of federal taxation stacks up against these criteria. While any comprehensive evaluation of this question goes well beyond the objectives of this text, we offer the following brief comments:

- With respect to equity, Canada continues to have situations in which high income individuals pay little or no tax and relatively low income individuals are subjected to fairly high effective rates. While the alternative minimum tax was instituted to correct this problem, inequity is unlikely to be eliminated in a tax system that attempts to accomplish as many diverse objectives as does the current Canadian system.
- As noted previously, the Canadian system has a very heavy reliance on the taxation of personal income and receives a very low portion of its revenues from the corporate income tax. Also on the low side is the contribution of the GST.
- The Canadian system has had problems with stability and dependability of revenues.

- The Canadian tax system is very complex, making compliance difficult for many taxpayers. In addition, administration of the legislation is made more difficult by the large number of provisions and the lack of clarity in their content.

  The inability to achieve a harmonized GST/HST system has made this situation much worse. As we have noted, different provinces have adopted different systems, thereby complicating inter-provincial transactions. Further, in a given province, there are significant variations in the types of goods and services that are subject to taxation within a given system.

- With respect to international competitiveness, the situation is similar for corporations and individuals vis-a-vis the United States.
  - Over the last few years, tax rates on Canadian corporations have been reduced. These reductions leave Canada with corporate rates that compare very favorably with most foreign jurisdictions. However, this situation has changed dramatically in 2018 with the Trump sponsored reduction in the maximum U.S. corporate rate from 35 percent to 21 percent.
  - Increasing the maximum federal tax rate on individuals to 33 percent in 2016 has made Canada less competitive with other countries, particularly the United States. With provincial taxes considered, several provinces tax individuals at a maximum rate of 54 percent. This compares to a maximum rate in some U.S. venues of 37 percent.

**We suggest you work Self Study Problem One-3 at this point.**

# Income Tax Reference Materials

## Introduction

1-44. To this point in our discussion of the Canadian tax system and related tax policy concepts, we have considered a variety of taxation bases as they apply at both the federal and provincial level. However, with the exception of Chapter 21 which deals with the goods and services tax, the focus of this book is on the federal taxes that are assessed on the income of individuals, corporations, and trusts.

1-45. Reference materials related to the federal income tax are very extensive. In addition to the *Income Tax Act*, there are many other sources of information. These include other legislative materials, other publications of the Canada Revenue Agency (CRA), documents related to court decisions, as well as interpretive materials from a wide variety of sources.

1-46. If presented in paper format, a complete library of these materials would run to thousands of pages and would have to be included in a large number of separate volumes. Given this, almost all tax practitioners work with an electronic database that provides for easy access through key word searches.

1-47. These electronic databases are published by several Canadian organizations, including CCH, Carswell, and CPA Canada. Through our affiliation with CPA Canada, we are able to provide you with access to their Federal Income Tax Collection (FITAC). Instructions on how to access this electronic database are available online through the MyLab for this text. FITAC includes:

- The *Income Tax Act* and *Income Tax Regulations*.
- Most CRA publications including Income Tax Folios, Interpretation Bulletins, Information Circulars, Guides, and forms.
- An electronic copy of this text, without problem material, that is searchable and has electronic links to other reference materials in the database.

1-48. A description of all of these materials will be found in the sections which follow.

**Figure 1 - 2 Basic Structure Of The Income Tax Act**

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| **Part I - XIX** (in **Divisions** and **Subdivisions**) | → | **Section** (1 - 281) | → | **Subsection** (Arabic numeral) | → | **Paragraph** (lower case letter) | → | **Subparagraph** (lower case Roman numeral) |

# The Income Tax Act

## *Importance*

1-49. This is the most important source of information for dealing with matters related to the federal income tax. Interpretation and guidance can be found in many other sources. However, at the end of the day, this document provides the basis for any final decision related to the amount of income tax that will have to be paid by an individual, corporation, or trust.

1-50. It is a very long document, running over 2,500 pages in paper format. It is also written in a very legalistic style which, in our opinion, cannot be readily understood by most individuals. Given this, the design of our text is such that it does not require the use of the *Income Tax Act* in order to understand its content or complete the related problem material.

1-51. While the design of this text does not require the use of the *Income Tax Act* as a reference, it is still important to have some understanding of the structure of this document. One reason for this is that the organization of this book generally follows the structure of the *Income Tax Act*. In addition, you will find many references to the *Act* embedded as part of the text. There are two reasons for this:

- The most important reason for these references is to allow interested individuals to explore a particular issue to a depth that goes beyond the scope of this text. The presence of *Income Tax Act* references greatly facilitates this process.
- The use of references can also be convenient. In dealing with a particular subject, it is often more efficient to refer to a subject with a reference to the *Act* than to repeatedly use the full description of the subject.

1-52. Given these considerations, we will provide a description of the basic structure and content of this important legislation.

## *Structure Of The Federal Income Tax Act*

1-53. Figure 1-2 diagrams the basic structure of the *Act*. As can be seen in this diagram, the major divisions of the *Income Tax Act* are referred to as Parts. Some, but not all of these Parts, contain two or more Divisions (e.g., Part I of the *Act* contains Divisions A through J). Some Divisions, but again not all of them, contain Subdivisions. For example, Division B of Part I contains Subdivisions a through k. Note that, while the Parts are numbered I through XIX, there are more than 19 Parts. This reflects the fact that when a new Part is added, it has been more convenient to attach a decimal designation to the new Part, as opposed to renumbering all of the Parts that follow the new Section. For example, Part I is followed by Part I.01, Part I.1, Part I.2, and Part I.3.

1-54. All of the Parts contain at least one Section. However, there is considerable variance in the size of the Parts. Part I.2, "Tax On Old Age Security Benefits", contains only one Section. In contrast, Part I, the largest and most important Part of the *Act*, contains Sections 2 to 180.

1-55. The Sections are labeled 1 through 281. However, as was the case with Parts of the *Act*, decimals are used to label new Sections. For example, Section 12 is followed by Section 12.1, Section 12.2, Section 12.3 (repealed), Section 12.4, Section 12.5, and Section 12.6.

1-56. Sections may be further subdivided into Subsections [designated with Arabic numerals as in Subsection 84(1)]. This is followed by Paragraphs [designated with lower case letters as in Paragraph 84(1)(b)], and by Subparagraphs [designated with lower case Roman

numerals as in Subparagraph 84(1)(b)(i)]. In some cases, the outlining process goes even further with Clauses (designated with upper case letters) and Subclauses (designated with upper case Roman numerals). Putting all of this together means that the reference:

**ITA 115(1)(a)(i)(A)(I)**

would be read as *Income Tax Act* Section 115, Subsection (1), Paragraph (a), Subparagraph (i), Clause A, Subclause I. Normally the relevant Part of the *Act* (Part I in this case) is not indicated in such references.

### Parts Of The Act

1-57. The Parts of the *Income Tax Act* are numbered I through XVII. As noted, because of the use of decimal designations there are more than 17 Parts.

1-58. About 70 percent of the Sections of the *Income Tax Act* are found in Part I, which is titled "Income Tax". This Part contains Sections 2 through 180 of the *Act* and, because of its importance, we will provide a more detailed description of this Part in the following material.

1-59. Parts I.01 through XIX cover a variety of special taxes as well as rules related to matters of administration, enforcement, and interpretation. For example, Part V is titled "Tax And Penalties In Respect Of Qualified Donees" and Part XII.3 is titled "Tax On Investment Income Of Life Insurers". As the great bulk of our attention in this text will be focused on Part I of the *Act*, there is little point in providing a list of these Parts for you to read. However, if you have further interest in their content, we would refer you to the complete copy of the *Income Tax Act* that is included in the FITAC database, which can be installed from the MyLab for this text.

### Part I Of The Act

1-60. Part I, the largest and most important Part of the *Income Tax Act*, is divided into eleven Divisions. Some of these Divisions are further divided into Subdivisions. The Divisions and their more significant Subdivisions are described in the following paragraphs:

**Division A**: "Liability For Tax" (ITA Section 2) This short Division is concerned with the question of who is liable for payment of income tax in Canada. This Division will be covered in this Chapter 1.

**Division B**: "Computation Of Income" (ITA Sections 3 through 108) This is the longest Division in Part I and concerns itself with the determination of Net Income For Tax Purposes. Its first five Subdivisions describe the major sources of income and deductions and are as follows:

- **Subdivision a** - "Income Or Loss From An Office Or Employment" This Subdivision deals with the ordinary wages and salaries that are earned by individuals while as an employee. The material in this Subdivision provides the basis for Chapter 3.
- **Subdivision b** - "Income Or Loss From A Business Or Property" This Subdivision deals with business income earned by corporations, trusts, and by individuals through proprietorship or partnership arrangements. Also covered in this Subdivision is property income which includes rents, interest, dividends, and royalties. The material in this Subdivision provides the basis for Chapters 5, 6, and 7.
- **Subdivision c** - "Taxable Capital Gains And Allowable Capital Losses" This Subdivision deals with gains and losses resulting from the disposal of capital property. The material in this Subdivision is dealt with in Chapter 8.
- **Subdivision d** - "Other Sources Of Income" Covered here are miscellaneous income sources, such as spousal support received and various types of pension income, that do not fit into any of the major categories dealt with in Subdivisions a, b, and c. This material is covered in Chapter 9.

- **Subdivision e** - "Deductions In Computing Income" Covered here are miscellaneous deductions such as moving expenses, child care costs, and spousal support paid. These are deductions that do not fit into any of the categories in Subdivisions a, b, and c. This material is also covered in Chapter 9.

Subdivisions a, b, and c each provide for both inclusions and deductions and, as a consequence, require the calculation of a net income figure. The deductions that are specified in Subdivisions a, b and c can only be deducted from inclusions in that same Subdivision. That is, deductions related to business income (Subdivision b) cannot be deducted from the inclusions for employment income (Subdivision a). This becomes a very important point when the inclusions in a particular Subdivision are not sufficient to support all of the available deductions in that Subdivision.

The remaining six Subdivisions of Division B do not provide new sources of income but, rather, provide additional rules related to the determination of Net Income. These remaining Subdivisions are as follows:

- **Subdivision f** - "Rules Relating To Computation Of Income" This Subdivision contains a variety of rules related to the deductibility of expenses, income attribution, and the death of a taxpayer. These rules are covered in Chapters 6 and 9.
- **Subdivision g** - "Amounts Not Included In Computing Income" This is a very specialized Subdivision, dealing with certain types of exempt income. It is not given significant coverage in this text.
- **Subdivision h** - "Corporations Resident In Canada And Their Shareholders" This Subdivision presents a number of rules related to the taxation of Canadian resident corporations. This material is covered in Chapters 12, 13, and 14.
- **Subdivision i** - "Shareholders Of Corporations Not Resident In Canada" This is a specialized Subdivision. Limited coverage is available in Chapter 20.
- **Subdivision j** - "Partnerships And Their Members" This Subdivision, dealing with rules related to partnerships, is given detailed coverage in Chapter 18.
- **Subdivision k** - "Trusts And Their Beneficiaries" This Subdivision, dealing with the taxation of trusts, is given detailed consideration in Chapter 19.

**Division C**: "Computation Of Taxable Income" (ITA Sections 109 through 114.2) This Division covers the conversion of Division B income (commonly referred to as Net Income For Tax Purposes, or simply Net Income) into Taxable Income for residents. For individuals, it is given initial coverage in Chapter 4, followed by more detailed coverage in Chapter 11. For corporations, the coverage is in Chapter 12.

**Division D:** "Taxable Income Earned In Canada By Non-Residents" (ITA Sections 115 through 116) Coverage of this material can be found in Chapter 20.

**Division E**: "Computation Of Tax" (Sections 117 through 127.41) This Division is concerned with determining the taxes that are payable on the Taxable Income determined in Divisions C and D. It has seven Subdivisions as follows:

- Subdivision a - Rules applicable to individuals
- Subdivision a.1 - Canada Child Benefit
- Subdivision a.2 - Working Income Tax Benefit
- Subdivision a.3 - Child Fitness Tax Credit (Repealed)
- Subdivision a.4 - School Supplies Tax Credit
- Subdivision b - Rules applicable to corporations
- Subdivision c - Rules applicable to all taxpayers

The computation of tax for individuals is largely covered in Chapter 4, with some additional coverage in Chapter 11. The corresponding material for corporations is found in Chapters 12 and 13.

**Division E.1**: "Minimum Tax" (Sections 127.5 through 127.55) This Division is concerned with the obligation of individuals to pay a minimum amount of tax, as well as the computation of this alternative minimum tax. This material is covered in Chapter 11.

**Division F**: "Special Rules Applicable In Certain Circumstances" (Sections 128 through 143.4) Much of this Division is devoted to very specialized situations (bankruptcies) or organizations (cooperative corporations). While these situations are not given coverage in this text, the Division overs two subjects that are of more general importance. These are immigration to, and emigration from, Canada which are covered in Chapter 20, and refundable dividends for private corporations which is covered in Chapter 13.

**Division G**: "Deferred And Other Special Income Arrangements" (Sections 144 through 148.1) This important Division covers the rules related to Registered Retirement Savings Plans, Registered Pension Plans, Deferred Profit Sharing Plans, as well as other deferred income arrangements. Detailed attention is given to this material in Chapter 10.

**Division H:** "Exemptions" (Sections 149, through 149.2) Covered here are exemptions for individuals and organizations such as certain employees of foreign countries, pension trusts, and charitable organizations. These topics are not given coverage in this text.

**Divisions I And J**: "Returns, Assessments, Payment And Appeals" and "Appeals To The Tax Court Of Canada And The Federal Court" (Sections 150 through 180) These Divisions deal with the resolution of disputes between taxpayers and the Canada Revenue Agency (CRA). Limited coverage of this material is found in Chapter 2.

## Other Income Tax Legislation

1-61. While the *Income Tax Act* constitutes the major source of legislation relevant to the study of federal income tax, there are three other sources of legislative materials that are relevant. These are draft legislation, the Income Tax Regulations and a group of International Tax Treaties between Canada and other countries. A general description of these legislative materials follows.

### *Draft Legislation*

1-62. It is traditional for the federal government to issue a Budget in the first half of each year. Budgets are presented as a Notice Of Ways And Means Motion. As such, its content is of a general nature and does not contain the actual legislative provisions that are required to implement the proposals that are being put forward. The preparation of this legislation takes a considerable period of time and, when it is completed, it is presented as draft legislation. Additional time will pass before this draft legislation is passed by Parliament.

1-63. These time lags can create a somewhat difficult situation in which returns for a particular taxation year must sometimes be filed prior to the actual passage of the legislation relevant to that year. Tax planning can be further complicated by an election call by the governing party. This may be the case in 2019. While the budget was presented on March 19, 2019, an election must be held prior to October 22, 2019. The legislation to implement this budget may never see the light of day if the Liberals were to lose their majority in Parliament.

### *Income Tax Regulations*

1-64. Section 221 of the *Income Tax Act* allows the Governor In Council to make Regulations concerning the administration and enforcement of the *Income Tax Act*. Some of the items listed in this Section include:

- prescribing the evidence required to establish facts relevant to assessments under this *Act*;

- requiring any class of persons to make information returns respecting any class of information required in connection with assessments under this *Act*;
- prescribing anything that, by this *Act*, is to be prescribed or is to be determined or regulated by regulation; and
- defining the classes of persons who may be regarded as dependent for the purposes of this *Act*.

1-65. While these Regulations cannot extend the limits of the law, they can serve to fill in details and, to some extent, modify the statutes. For example, most of the rules for determining the amount of Capital Cost Allowance that can be deducted are established in the Regulations. Such Regulations provide an essential element of flexibility in the administration of the *Act* in that they can be issued without going through a more formal legislative process.

1-66. You should also note that references to material in the Regulations are often referred to in the *Income Tax Act* as "prescribed". For example, the rate the CRA charges on late tax payments, a "prescribed" rate of interest, is determined by a procedure that is described in Regulations 4301 and 4302.

### International Tax Treaties

1-67. Canada currently has tax treaties (also known as tax conventions) with nearly 100 countries. The most important of these are the Tax Conventions with the United States and the United Kingdom. While there is considerable variation in the agreements, most of them are based on the model convention developed by the Organization For Economic Co-operation And Development (OECD).

1-68. The purpose of these treaties is twofold. First, they attempt to avoid double taxation of taxpayers who may have reason to pay taxes in more than one jurisdiction and, second, they try to prevent international evasion of taxes. In situations where there is a conflict between the Canadian *Income Tax Act* and an international tax treaty, the terms of the international tax treaty prevail.

1-69. Chapter 20 will provide additional discussion of Canada's tax treaties. Particular attention will be given to the tax treaty between Canada and the U.S.

### Income Tax Application Rules, 1971

1-70. When capital gains taxation was introduced in Canada in 1972 (more than 40 years ago), a large number of transitional rules were required, primarily to ensure that the effects of the new legislation were not retroactive. These transitional rules are called the Income Tax Application Rules, 1971, and they can be of some significance in certain situations involving pre-1972 assets.

## Other Sources Of Income Tax Information

### Electronic Library Resources

1-71. As noted in Paragraph 1-46, most tax practitioners rely on an electronic library for their tax reference materials. Also as noted, the MyLab for this text provides access to one of these libraries — CPA Canada's Federal Income Tax Collection (FITAC).

### CRA Website

1-72. The CRA has an extensive website at **www.canada.ca/en/services/taxes**. Almost all of the forms, Guides, Income Tax Folios, Interpretation Bulletins and other documents provided by the CRA that are described in Paragraph 1-73 are available on the website. The forms and publications can be viewed and printed online or downloaded to a computer in one or more formats. The website is constantly being expanded to provide more forms and publications and more personalized information on a taxpayer's various tax accounts.

### CRA Publications

1-73. The CRA provides several publications to the public which, while they do not have the force of law, can be extremely helpful and influential in making decisions related to income taxes. These can be described as follows:

**Income Tax Folios** In 2013, the CRA introduced a new type of technical publication, called Income Tax Folios, a.k.a. IT Folios or simply Folios. Their goal is to update the information currently found in Interpretation Bulletins and to introduce improved web functionality. The Income Tax Folios are organized into seven Series with each Series divided into Folios that contain Chapters on specific topics. For example, under Series 1, Individuals, Folio 1 is Health and Medical, and Chapter 1 covers the Medical Expense Tax Credit. This Chapter is designated S1-F1-C1, which stands for Series 1, Folio 1, Chapter 1.

This is, of course, a huge project that will require a number of years to complete. As an indication of this, as of March 1, 2019, only 39 Chapters have been released. While there cannot be a direct comparison, the Interpretation Bulletins they are designed to replace number over 500.

With respect to this text, we will reference those Folios that have been issued up to March 1, 2019.

**Interpretation Bulletins** As noted, over 500 Interpretation Bulletins were issued by the CRA prior to 2013, though many of these have been cancelled. The objective of these Bulletins was to give the CRA's interpretation of particular sections of the law that it administers and to announce significant changes in departmental interpretation along with the effective dates of any such changes. An example of an important Interpretation Bulletin still in effect at the time of writing (March, 2019) is IT-63R5 which deals with an employee's personal use of an automobile supplied by an employer.

The CRA stopped issuing new Interpretation Bulletins in 2003, but continued to issue many revisions until 2013. The content of the existing Bulletins is being gradually replaced by the series titled Income Tax Folios (see preceding material).

**Information Circulars** While over 300 of these circulars have been issued, there are currently about 60 in effect. The objective of these publications is to provide information regarding procedural matters that relate to both the *Income Tax Act* and the provisions of the Canada Pension Plan, and to announce changes in organization, personnel, operating programs, and other administrative developments.

**Guides And Pamphlets** The CRA publishes a large number of non-technical Pamphlets and Guides that provide information on particular topics of interest to taxpayers. Examples of Pamphlets are "Canadian Residents Going Down South" (P151) and "Tax Information For People With Disabilities" (P149). Examples of Guides are "Business And Professional Income" (T4002), "Preparing Returns For Deceased Persons" (T4011), and "RRSPs And Other Registered Plans For Retirement" (T4040).

**CRA News Releases, Tax Tips, And Fact Sheets** The CRA publishes News Releases on a variety of subjects, such as prescribed interest rates, corporate EFILE, deferral of taxation on employee stock options, and maximum pensionable earnings. They also provide information on when monthly payments will be released under the Canada Child Benefit system and when quarterly payments will be released under the GST tax credit program. Some of the News Releases take the form of questions and answers, while others deal with the subject in some depth.

**Advance Income Tax Rulings And Technical Interpretations** In recognition of the considerable complexity involved in the interpretation of many portions of the *Income Tax Act*, the Income Tax Rulings Directorate of the CRA will, for a fee, provide an Advance Income Tax Ruling on how it will tax a proposed transaction, subject to certain limitations and qualifications. Advance Income Tax Rulings are available to the public, but only in severed format with much of the relevant information that may permit identification of the parties deleted. The result is that such publications are of questionable value.

The Income Tax Rulings Directorate of the CRA also provides both written and telephone Technical Interpretations to the public (other than for proposed transactions where an Advance Income Tax Ruling is required) free of charge. Such interpretations however are not considered binding on the CRA.

**Income Tax Technical News** Prior to 2012, the CRA issued newsletters titled *Income Tax Technical News* which provided up-to-date information on current tax issues. None have been issued since 2011 and existing newsletters are being cancelled as new Income Tax Folios are gradually incorporating their content.

### Court Decisions

1-74. Despite the huge volume of information available for dealing with income tax matters, disputes between taxpayers and the CRA regularly find their way into the Canadian court system. Of the hundreds of tax cases that are reported each year, the great majority do not involve tax evasion or other criminal offences. Rather, they involve an honest difference of opinion between the taxpayer and the CRA. Common areas of litigation include:

- the deductibility of both business and employment related expenses;
- whether an individual is working as an employee or an independent contractor;
- establishing a property's fair market value;
- the question of whether a transaction took place at arm's length;
- the deductibility of support payments;
- distinguishing between profits that are capital in nature and those that are ordinary business income; and
- the deductibility of farm losses against other sources of income.

1-75. With the large number of court cases and the fact that they cover the great majority of issues that might arise in the application of income tax legislation, attention must be given to the precedents that have been established in the court decisions. While court decisions cannot be used to change the actual tax law, court decisions may call into question the reasonableness of interpretations of the ITA made by either the CRA or tax practitioners. Given the volume and complexity of court cases on income tax, we will cite only very important cases in our coverage of the various subjects in this text. However, a careful review of all relevant case material would be essential in researching any complex tax issue.

**We suggest you work Self Study Problem One-4 at this point.**

# Liability For Part I Income Tax

## Background

1-76. The *Income Tax Act* contains a number of Parts that deal with assessing taxes on various taxpayers. For example, Part VI assesses a tax on the capital of financial institutions, while Part XIII provides for a tax that is assessed largely on the property income of non-residents.

1-77. While recognizing that these other types of taxes exist, the focus of this Chapter is on Part I tax. In terms of terminology, the portion of any tax legislation that specifies who is liable to pay tax is called a charging provision. With respect to Part I tax, the relevant charging provision is found in ITA 2. There are two components to this charging provision. The first, ITA 2(1) specifies the applicability of Part I tax to residents. The second, ITA 2(3), specifies the situations where non-residents will be taxed under Part I.

1-78. In this Chapter we will give detailed consideration to the application of Part I tax to residents, including a complete discussion of the meaning of "resident". Some attention will also be given to the Part I tax liability of non-residents. Detailed consideration of this topic is available to Chapter 20, "International Issues In Taxation".

1-79. We would note that taxes assessed under other Parts of the *Income Tax Act* will be given some attention in other Chapters. In particular, Chapter 20 will deal with taxation of foreign source income of Canadian residents, as well as the application of Part XIII to non-residents.

## Charging Provision For Canadian Residents

1-80. The Part I charging provision for Canadian residents is as follows:

> **ITA 2(1)** An income tax shall be paid, as required by this *Act*, on the taxable income for each taxation year of every person resident in Canada at any time in the year.

1-81. There are several terms used in this charging provision that require further explanation:

**Person** The charging provision makes it clear that responsibility for paying the federal income tax lies with "persons". As explained in Paragraph 1-8, in contrast to its usual dictionary meaning (i.e., human being), the *Income Tax Act* uses this term to refer to individuals, corporations, and trusts. When a provision of the *Act* is directed at human taxpayers, the term "individual" is generally used.

This reference establishes the fact that there are three entities which must file income tax returns — individuals, corporations, and trusts.

**Resident** ITA 2(1) also establishes that Canadian residents are liable for Canadian income tax, without regard to their citizenship. This is in contrast to the situation in the United States where U.S. citizens are liable for U.S. income taxes, without regard to where they reside.

While the *Income Tax Act* does not provide a definition of resident, in many cases the application of this concept is self-evident. For an individual who has lived and worked in Red Deer, Alberta for his entire life, never leaving Canada even for short vacations, it is not difficult to establish Canadian residency.

However, for corporations and trusts, as well as for individuals in certain types of circumstances, determining residency can become a fairly complex process. It is also, because of the large differences in tax rates in alternative jurisdictions, a matter of some importance. Detailed consideration of the issues related to residency can be found in the next major Section of this Chapter.

**Taxation Year** The term taxation year is defined in ITA 249(1). The general rule, which applies to all individuals and to most trusts, is that the taxation year is a calendar year. There are, however, two exceptions to this general rule:

> **Corporations** For a corporation, the taxation year is defined as a "fiscal period". ITA 249.1 goes on to define fiscal period as a period for which accounts are made up that does not exceed 53 weeks. These definitions establish the fact that corporations are not required to use the calendar year as their taxation year.
>
> **Graduated Rate Estates** Without going into detail, a "graduated rate estate" is a trust that arises at the time of an individual's death. Such trusts can continue for up to 36 months after the date of death and, during that 36 month period, such trusts can use a non-calendar taxation year. For more information on this type of trust, see Chapter 19, Trusts And Estate Planning.

**Taxable Income** Taxable income is defined in Section 2 of the *Act* as follows:

> **ITA 2(2)** The taxable income of a taxpayer for a taxation year is the taxpayer's income for the year plus the additions and minus the deductions permitted by Division C.

The process of converting Net Income For Tax Purposes into Taxable Income will be given some attention at a later point in this Chapter. However, detailed coverage will be found in Chapters 4 and 11.

## Charging Provision For Non-Residents

### General Charging Provision

1-82. The second charging provision in the *Income Tax Act* deals with the taxation of non-residents. It is as follows:

> **ITA 2(3)** Where a person who is not taxable under subsection (1) for a taxation year
>
> (a) was **employed** in Canada,
> (b) carried on a **business** in Canada, or
> (c) disposed of a **taxable Canadian property**,
>
> at any time in the year or a previous year, an income tax shall be paid, as required by this *Act*, on the person's taxable income earned in Canada for the year determined in accordance with Division D.

1-83. As noted, we will give very limited attention to the taxation of non-residents in this Chapter. The comments in this Chapter are very general and do not take into consideration the many complexities that exist in this area. In particular, the significant influence that tax treaties with other countries can have on the taxation of non-residents is given only superficial consideration in this Chapter 1. Detailed consideration of the issues associated with the taxation of non-residents, under Part I as well as other Parts of the *Income Tax Act*, will be found in Chapter 20.

### Employment Income Earned By Non-Residents

1-84. As the term is used in ITA 2(3)(a), Canadian employment income refers to income earned by a non-resident while working as an employee in Canada, generally without regard to the location of the employer. An example of this would be a U.S. citizen who is a resident of Detroit, Michigan, but is employed at an automobile plant in Windsor, Ontario. Such an individual would, in general, be subject to Canadian taxes on his employment income. However, as the individual is a non-resident, his other sources of income would not be taxed in Canada.

### Business Income Earned By Non-Residents

1-85. The second situation in which non-residents are subject to Canadian taxes is specified in ITA 2(3)(b). This paragraph indicates that persons who carried on business in Canada during a taxation year are subject to Canadian taxes on that income. Many of the difficulties associated with implementing this provision are related to determining what constitutes "carrying on business in Canada". This clearly includes producing or manufacturing products in Canada. In addition, ITA 253 indicates that it includes situations where a business is offering things for sale in Canada through an employee.

1-86. This broad interpretation is, however, mitigated in those circumstances where the non-resident is a resident of a country with which Canada has a tax treaty. For example, if a U.S. corporation had sales staff selling products in Canada, ITA 253 would suggest that it should be taxed as a non-resident carrying on business in Canada. However, the Canada-U.S. tax treaty overrides ITA 253 in that this agreement exempts a U.S. enterprise from Canadian taxation unless it is carrying on business through permanent establishments in Canada.

1-87. It is also important to distinguish between those situations in which a non-resident is offering something for sale in Canada through an employee and those situations in which a non-resident is selling to an independent contractor who resells the item in Canada. In the former case, the non-resident person is carrying on business in Canada, while in the latter case the non-resident is not.

### Dispositions Of Taxable Canadian Property By Non-Residents

1-88. ITA 2(3)(c) specifies the third situation in which non-residents are subject to Canadian taxation. This provision indicates that non-residents are subject to Canadian taxation on gains resulting from the disposition of "taxable Canadian property".

1-89. The concept of taxable Canadian property is discussed more completely in Chapter 20. However, you should note at this point that the major items included in taxable Canadian property are:

- Real property, a.k.a., real estate situated in Canada.
- Certain capital property and inventories of a business carried on in Canada.
- A share of an unlisted corporation, an interest in a partnership, or an interest in a trust if, at any time within the preceding 60 months, more than 50 percent of the fair market value of the share or interest was derived from certain properties including Canadian real property, Canadian resource properties and timber resource properties.
- A share of a listed corporation only if, at any time within the preceding 60 months, at least 25 percent of the issued shares of any class were owned by the non-resident taxpayer and/or non-arm's length persons, and more than 50 percent of the shares' fair market value was derived from certain properties including Canadian real property, Canadian resource properties and timber resource properties.

1-90. This provision means that, if a resident of the state of Washington sells a vacation property that he owns in Whistler, British Columbia, any gain on that sale will be subject to Canadian taxation.

1-91. To help solve the problems arising from difficulties associated with collecting taxes from non-residents, ITA 116(5) indicates that, if there is a gain from the sale of taxable Canadian property by a non-resident, the person purchasing the property is responsible for the required taxes (see Chapter 20 for a discussion of the relevant 25 percent tax withholding). Exceptions to this occur if:

- the purchaser had no reason to believe that the seller of the property was a non-resident;
- the minister has issued a clearance certificate indicating that the non-resident has made arrangements for paying the taxes.

### Property Income Earned By Non-Residents

1-92. The charging provisions in ITA 2 do not cover Canadian source property income of non-residents (e.g., rents, interest, or royalties). However, this type of income is covered in Part XIII of the *Act*. The general provision in Part XIII requires a flat 25 percent tax be withheld on Canadian property income paid to non-residents. This 25 percent tax rate is usually reduced for payments to non-residents in countries where Canada has a tax treaty.

1-93. This tax is withheld at the source of income, is based on the gross amount of such income, and no provision is made for any expenses related to acquiring the income. Since this inability to deduct expenses could result in serious inequities, there are provisions that allow a non-resident to elect to file a Canadian tax return for certain types of property income under Part I of the *Act*. These Part XIII tax provisions are discussed more thoroughly in Chapter 20 which deals with international issues in taxation.

## Exercise One - 5

**Subject:** Non-Resident Liability For Tax

Ms. Laurie Lacombe, a U.S. citizen, has Canadian employment income of $22,000. She lives in Blaine, Washington and is a resident of the United States for the entire year. Ms. Lacombe does not believe that she is subject to taxation in Canada. Is she correct? Explain your conclusion.

**SOLUTION available in print and online Study Guide.**

# Residence

## Importance

1-94. As discussed, the charging provision for Part I of the *Income Tax Act* indicates that this tax is applicable to any person that is a resident of Canada. If a person is considered a resident of Canada in a given year, that person will be subject to Part I for that year on all sources of income, regardless of where that income is earned. Alternatively, if the person is a non-resident, Part I tax will only apply to Canadian employment income, Canadian business income, and gains on the disposition of Taxable Canadian Property.

1-95. Residency status is determined by applying certain rules and guidelines that originate from jurisprudence, common law, the *Income Tax Act*, and tax treaties. These rules vary depending on whether the person is an individual, corporation, or trust. In the material that follows, we will give detailed consideration to the rules applicable to each of these categories of taxpayers.

## Residence Of Individuals

### *General Concept*

1-96. For the average Canadian individual whose job, family, dwelling place, and other personal property are all located in Canada, the concept of residence is not at all ambiguous. Such individuals would clearly be Canadian residents and, as a result, they would be liable for Canadian taxation on their worldwide income. Short departures from the country for holidays or business activities would not have any effect on this conclusion.

1-97. However, for a growing number of individuals, the question of residence is more complex. It is also an important question. As tax rates and tax rules in different countries vary tremendously, the location of a person's residence can have a significant impact on the amount of taxes that will have to be paid.

1-98. While the term resident is not specifically defined in the *Income Tax Act*, Income Tax Folio, S5-F1-C1, *Determining An Individual's Residence*, provides extensive guidance in this area. The most generally applicable statement in this IT Folio is as follows:

> **Paragraph 1.10** The most important factor to be considered in determining whether an individual leaving Canada remains resident in Canada for tax purposes is whether the individual maintains residential ties with Canada while abroad. While the residence status of an individual can only be determined on a case by case basis after taking into consideration all of the relevant facts, generally, unless an individual severs all significant residential ties with Canada upon leaving Canada, the individual will continue to be a factual resident of Canada and subject to Canadian tax on his or her worldwide income.

1-99. Paragraph 1.11 of S5-F1-C1 goes on to point out that the ties that will almost always be considered significant are:

> **Dwelling** If an individual maintains a dwelling place in Canada, it will generally result in the individual being considered a resident. One possible exception to this rule would be when an individual who leaves Canada rents out a former dwelling place to an arm's length party. In this type of situation, owning a Canadian residence may not be considered a residential tie.
>
> **Spouse Or Common-Law Partner** If an individual has a spouse or common-law partner who remains in Canada, it will generally result in the individual being considered a Canadian resident. An exception here would be when the individual was living separate or apart from the spouse or common-law partner prior to their departure from Canada.
>
> **Dependants** If an individual has dependants, such as minor children, who remain in Canada, it will generally result in the individual being considered a Canadian resident.

1-100. S5-F1-C1 also implies that, even in the absence of one of the preceding ties, an individual may still be considered to be a resident of Canada on the basis of secondary residential ties. Paragraph 1.14 contains the following examples of secondary residential ties:

- personal property in Canada (such as furniture, clothing, automobiles, and recreational vehicles);
- social ties with Canada (such as memberships in Canadian recreational or religious organizations);
- economic ties with Canada (such as employment with a Canadian employer and active involvement in a Canadian business, and Canadian bank accounts, retirement savings plans, credit cards, and securities accounts);
- landed immigrant status or appropriate work permits in Canada;
- hospitalization and medical insurance coverage from a province or territory of Canada;
- a driver's license from a province or territory of Canada;
- a vehicle registered in a province or territory of Canada;
- a seasonal dwelling place in Canada or a leased dwelling place;
- a Canadian passport; and
- memberships in Canadian unions or professional organizations.

1-101. S5-F1-C1 notes that these secondary ties must be looked at collectively and that it would be unusual for a single secondary tie to be sufficient for an individual to be classified as a Canadian resident.

## Exercise One - 6

**Subject**: Residential Ties

At the end of the current year, Simon Farr departed from Canada in order to take a permanent position in Ireland. He was accompanied by his wife and children, as well as all of his personal property. Due to depressed real estate prices in his region, he was unable to sell his residence at a satisfactory price. However, he was able to rent it for a period of two years. He also retained his membership in CPA (Chartered Public Accountants) Ontario. After his departure, would he still be considered a Canadian resident for tax purposes? Explain your conclusion.

**SOLUTION available in print and online Study Guide.**

### *Temporary Absences*

1-102. Many of the problems associated with establishing residency involve situations where an individual leaves Canada for a temporary period of time. The issue here is, under what circumstances should an individual be viewed as having retained their Canadian residency status during the period of their absence from Canada?

1-103. It is an important issue in that, if they are viewed as having retained their Canadian residency status, they will be subject to Canadian taxation on their worldwide income during the period of absence from Canada. While credits against Canadian income tax payable would usually be available for any income taxes paid in the foreign jurisdiction, the foreign taxes paid may be insufficient to cover the full Canadian tax liability.

1-104. S5-F1-C1 makes it clear that the length of the period of time during which the individual is absent from Canada is not a determining factor with respect to residency. If an individual severs all primary and secondary residential ties, it appears that he will cease to be a Canadian resident without regard to the period of his absence.

1-105. If some residential ties are retained during a temporary absence, other factors will be considered. As described in S5-F1-C1, these are as follows:

**Intent** The issue here is whether the individual intended to permanently sever residential ties with Canada. If, for example, the individual has a contract for employment, if and when he returns to Canada, this could be viewed as evidence that he did not intend to permanently depart. Another factor would be whether the individual complied with the rules related to permanent departures (i.e., as noted in Chapter 8, there is a deemed disposition of an individual's property at the time of departure from Canada, resulting in the need to pay taxes on any gains).

**Frequency Of Visits** If the individual continues to visit Canada on a regular and continuing basis, particularly if other secondary residential ties are present, this would suggest that he did not intend to permanently depart from Canada.

**Residential Ties Outside Of Canada** A further consideration is whether or not the individual establishes residential ties in another country. If someone leaves Canada and travels for an extensive period of time without settling in any one location, it will be considered as evidence that he has not permanently departed from Canada.

1-106. It is clear that there is considerable room for differences of opinion as to whether an individual has ceased to be a Canadian resident during a temporary absence from Canada. It is equally clear that the issue should be given careful attention by taxpayers who find themselves in this situation. The potential tax consequences of failing to deal properly with residency issues can be significant.

## Exercise One - 7

**Subject:** Temporary Absences

Jane is a Canadian citizen who is employed by a multi-national corporation. While she has worked for many years in the Canadian office of this organization, she agreed to transfer to the corporation's office in Florida. Before leaving, she disposed of her residence and other personal property that she did not wish to move. She canceled her Alberta driver's licence and health care card, and closed all of her Canadian banking and brokerage accounts.

Because her boyfriend remained in Edmonton, she flew back to Canada at least once a month. After 26 months, she decided that between the excessive heat and humidity in Florida and the travel required to maintain the relationship with her boyfriend, she would return to Canada. At this point, her boyfriend is not her common-law partner. Would Jane be considered a Canadian resident during the 26 months that she was absent from Canada? Explain your conclusion.

**SOLUTION available in print and online Study Guide.**

### *Part Year Residence*

1-107. In a year in which a person clearly commences or terminates residency in Canada, they will be taxed in Canada on their worldwide income for the part of the year in which they are resident in Canada. While the courts have indicated that establishing residence is a complex matter that involves many considerations, the date of entry will often be based on the immigration rules. However, for departures from Canada, Paragraph 1.22 of S5-F1-C1 indicates that the date on which an individual becomes a non-resident is the latest of:

- the date the individual leaves Canada,
- the date the spouse or common-law partner and/or other dependants of the individual leave Canada, and
- the date the individual becomes a resident of the country to which they are immigrating.

1-108. Situations involving part year residency require a fairly complex prorating of income, deductions, and personal tax credits. For example, an individual who is a resident of Canada for only part of the year will not be entitled to a full personal tax credit (see Chapter 4). The process for prorating such deductions and credits is specified in ITA 114 and ITA 118.91.

## Exercise One - 8

**Subject:** Part Year Residence

Mark is a Canadian citizen and, since graduating from university, has been employed in Vancouver. He has accepted a new position in the United States and, as of February 1 of the current year flies to Los Angeles to assume his responsibilities. (He has been granted a green card to enable him to work in the U.S.) His wife remains behind with their children until June 15, the end of their school year. On that date, they fly to Los Angeles to join Mark. Their residence is sold on August 1 of the current year, at which time a moving company picks up their furniture and other personal possessions. The moving company delivers these possessions to their new house in Los Angeles on August 15. Explain how Mark will be taxed in Canada during the current year.

## Exercise One - 9

**Subject**: Part Year Residence

Mr. Jonathan Kirsh was born in Kansas and, until the current year, had lived in various parts of the United States. On September 1 of the current year he moves to Lethbridge, Alberta to begin work at a new job. He brings his family and all of his personal property with him. However, he continues to have both a chequing and a savings account in a U. S. financial institution. Explain how Mr. Kirsh will be taxed in Canada during the current taxation year.

**SOLUTIONS available in print and online Study Guide.**

### *Sojourners And Other Deemed Residents*

1-109. Individuals who are considered Canadian residents on the basis of the residential ties that we have discussed are generally referred to as factual residents. ITA 250(1) extends the meaning of resident to include certain other individuals who are considered deemed residents. As we shall see, an individual can be a deemed resident even if they do not set foot in Canada in the relevant taxation years.

1-110. There are two important tax consequences associated with deemed residents:

- Deemed residents are taxed on their worldwide income for the entire taxation year. This is in contrast to part year residents who are only subject to Canadian taxation during that portion of the taxation year that they are present in Canada.

- Deemed residents are not deemed to reside in a specific province and, as a consequence, they are not subject to provincial taxes. In order to maintain fairness with other Canadian taxpayers, ITA 120(1) requires deemed residents to pay an additional federal tax equal to 48 percent of the basic federal tax that is otherwise payable. This will result in an overall tax liability that is either lower or higher than that of a factual resident, depending on the province that is being compared.

1-111. Included on the list of deemed residents of Canada are the following:

1. Sojourners in Canada for 183 days or more.
2. Members, at any time during the year, of the Canadian armed forces when stationed outside of Canada.
3. Ambassadors, ministers, high commissioners, officers or servants of Canada, as well as agents general, officers, or servants of a province, provided they were Canadian residents immediately prior to their appointment.
4. An individual performing services, at any time in the year, in a country other than Canada under a prescribed international development assistance program of the Government of Canada, provided they were resident in Canada at any time in the 3 month period preceding the day on which those services commenced.
5. A child of a deemed resident, provided they are also a dependant whose net income for the year was less than the base for the basic personal tax credit ($12,069 for 2019).
6. An individual who was at any time in the year, under an agreement or a convention with one or more other countries, entitled to an exemption from tax on substantially all of their income in any of those countries, because at that time the person was related to, or a member of the family of, an individual who was resident in Canada.

1-112. Of these items, numbers 1 and 6 require further explanation. With respect to item 1, a sojourner is an individual who is temporarily present in Canada for a period of 183 days or more during any one calendar year. Because of ITA 250(1), this person is deemed to be a Canadian resident for the entire year.

1-113. For this sojourner rule to apply, the individual must be a resident of another country during the 183 days in question. This means that an individual who gives up his residence in another country and moves to Canada early in a taxation year will be considered a part year resident, not a sojourner. Correspondingly, a Canadian resident who leaves Canada to take up residence in another country on September 1 will not be a sojourner, despite the fact that he is in Canada for more than 183 days in the year. As noted, this is an important distinction because the sojourner is liable for Canadian tax on his worldwide income for the entire year, not just the portion of the year when he was in Canada.

1-114. S5-F1-C1 indicates that sojourning means establishing a temporary residence and would include days spent in Canada on vacation trips. However, the Bulletin makes it clear that individuals who, for employment purposes, commute to Canada on a daily basis, are not considered to be sojourning.

1-115. Item 6 refers to situations where someone is exempt from tax in a foreign country because they are related to an individual who is a Canadian resident. For example, the spouse of a Canadian diplomat working in the U.S. would be exempt from U.S. income taxes under the governing international tax treaty because she is the spouse of the diplomat. As the diplomat would be a deemed resident of Canada under item 3, the spouse would be a deemed resident of Canada under item 6.

## Exercise One - 10

**Subject:** Individual Residency

Ms. Suzanne Blakey was born 24 years ago in Paris, France. She is the daughter of a Canadian High Commissioner serving in that country. Her father still holds this position. However, Ms. Blakey is now working in London. The only income that she earns in the year is from her London marketing job and is subject to taxes in England. She has never visited Canada. Determine the residency status of Suzanne Blakey.

**SOLUTION available in print and online Study Guide.**

### *Individuals With Dual Residency*

1-116. There are situations in which the application of the normal residency rules would result in an individual being considered a resident of more than one country. For example, a member of the Canadian armed forces is deemed to be a resident of Canada, but might also be considered a resident by the country in which he is stationed.

1-117. In the absence of some mechanism for dealing with the problem, such an individual could be subject to double taxation, with each country of residence assessing taxes on the basis of their domestic legislation. In such situations, the presence of an international tax treaty becomes crucial. These bilateral treaties contain provisions, generally referred to as tie-breaker rules, which are designed to provide relief from the potential double taxation that is inherent in dual residence situations.

1-118. While there is a general presumption that the provisions of international treaties override domestic tax legislation, these tie-breaker rules are of such importance that they are formally acknowledged in Canada's *Income Tax Act*. Specifically, ITA 250(5) indicates that a person is deemed not to be a resident of Canada if the terms of a particular tax treaty make him a resident of another country and not a resident of Canada.

1-119. As an example of a typical set of tie-breaker rules, the Canada/U.S. tax treaty resolves the dual residency problem for individuals by examining a list of factors. These factors are applied in the following order:

**Permanent Home** If the individual has a permanent home available in only one country, the individual will be considered a resident of that country. A permanent home means a dwelling, rented or purchased, that is continuously available at all times. For this purpose, a home that would only be used for a short duration would not be considered a permanent home.

**Centre of Vital Interests** If the individual has permanent homes in both countries, or in neither, then this test looks to the country in which the individual's personal and economic relations are greatest. Such relations are virtually identical to the ties that are examined when determining factual residence for individuals.

**Habitual Abode** If the first two tests do not yield a determination, then the country where the individual spends more time will be considered the country of residence.

**Citizenship** If the tie-breaker rules still fail to resolve the issue, then the individual will be considered a resident of the country where the individual is a citizen.

**Competent Authority** If none of the preceding tests resolve the question of residency then, as a last resort, the so-called "competent authority procedures" are used. Without describing them in detail, these procedures are aimed at opening a dialogue between the two countries for the purpose of resolving the conflict.

## Exercise One - 11

**Subject:** Dual Residency - Individuals

Using the tie breaker rules, determine the resident status of Dizzy and Donna for 2019 in the following two Cases:

**Case 1** Dizzy Jones is an unmarried saxophone player from Los Angeles who has always lived in the U.S. He decides to spend some time in Canada and arrives in Vancouver on May 5, 2019, looking for work in various nightclubs. A friend watches his home in Los Angeles while he is gone. He lives in boarding rooms and hotels throughout his time in Canada and returns to Los Angeles on February 14, 2020.

**Case 2** Donna, a U.S. citizen, lives in the state of New York. In the fall of 2018, while attending a business convention in Toronto, she met Donald. They decided to get married the following year and live permanently in the U.S. as soon as Donald could arrange his business affairs in Canada. In December, 2018, Donna took an eight month leave of absence from her job and gave notice to her landlord. On January 1, 2019, they moved in together, sharing an apartment in Toronto which was leased on a monthly basis while Donald finalized his business affairs. In August, 2019, they terminated the lease and returned to New York where they were married and purchased a house.

**SOLUTION available in print and online Study Guide.**

### *Residence Vs. Citizenship*

1-120. While Canada assesses taxes on the basis of residence, some other countries base the liability for tax on citizenship. Of particular importance in this regard is the United States. There are a significant number of Canadian resident individuals who are also citizens of the U.S. In the absence of mitigating legislation, such individuals would be taxed twice on most types of income.

1-121. Fortunately, the Canada/U.S. tax treaty provides for this situation. In very simplified terms, such individuals are allowed to credit Canadian taxes paid against their U.S. tax liability. As, in many cases, Canadian taxes on individuals are higher than U.S. taxes on a given amount of income, the U.S. tax liability may be eliminated.

1-122. Despite the fact that the balance owing to the U.S. is usually nil, U.S. citizens who are Canadian residents must file a U.S. tax return each year. If this important requirement is overlooked, it can lead to significant difficulties with U.S. tax authorities.

**We suggest you work Self Study Problems One-5, 6, and 7 at this point.**

## Residence Of Corporations

1-123. Being an artificial legal entity, a corporation does not reside anywhere in the same physical sense that the term applies to an individual. To some extent, the jurisdiction of incorporation can assist in finding an answer to the residency question. More specifically, ITA 250(4)(a) indicates that corporations which are incorporated in Canada after April 26, 1965 are deemed to be resident in Canada.

1-124. For corporations incorporated in Canada prior to April 27, 1965, ITA 250(4)(c) indicates that these corporations would also be treated as residents if at any time, in any taxation year ending after April 26, 1965:

- they were resident in Canada (under the mind and management concept discussed in the following Paragraphs), or
- carried on business in Canada.

1-125. What jurisdiction a company was incorporated in is not, however, the end of the story. If this were the case, it would be possible to escape Canadian taxation by the simple act of incorporating outside of the country. Beyond the rules described in the preceding Paragraph, a well established common law principle applies.

1-126. This is the idea that a corporation is resident in the jurisdiction in which the mind and management of the company are located. If the conclusion is that the mind and management of a corporation is in Canada, then a corporation that is not incorporated in Canada will be considered a resident for Canadian tax purposes. Note that, as this rule has been interpreted by the courts, mind and management resides where the highest functional decisions of a corporation are made, not where day-to-day decisions are made. It would appear that the most important factor in making this decision would be residence of the board of directors.

1-127. This "mind and management" criteria would also apply to a corporation that was incorporated in Canada prior to April 27, 1965. Such a corporation would become a resident if, at any time after April 26, 1965, its mind and management was located within Canada. Unlike the foreign jurisdiction corporation, which would be considered to be a Canadian resident only as long as the mind and management remained in Canada, a pre-April 27, 1965 Canadian corporation that became a resident because of the mind and management criteria would remain a Canadian resident, even if the mind and management were moved to a different jurisdiction.

### Corporations - Dual Residency

1-128. As was the case with individuals, a corporation may be considered to be resident in more than one country. For example, a corporation that was incorporated in Canada after April 26, 1965 might have its mind and management located in the U.S. This would make this company a deemed resident of Canada and a factual resident of the U.S.

1-129. In situations such as this, tax treaties again become very important. In the absence of such treaties, companies could be subject to taxation in both the countries where they are considered to be resident. As an example of such treaty provisions, the Canada/U.S. tax treaty indicates that, in situations where a company is considered to be a resident of both countries, the corporation will be deemed to be a resident only in the country in which it is incorporated.

## Exercise One - 12

**Subject:** Corporate Residency

Roswell Ltd. was incorporated in the state of New York in 2013. It carries on business in both the United States and Canada. However, all of the directors of the Company live in Kemptville, Ontario and, as a consequence, all of the directors meetings are held in Kemptville. Determine the residency status of Roswell Ltd.

## Exercise One - 13

**Subject:** Corporate Residency

Sateen Inc. was incorporated in Manitoba in 2012. However, since 2017, all of the Company's business has been carried on outside of Canada. Determine the residency status of Sateen Inc.

## Exercise One - 14

**Subject:** Dual Residency - Corporations

Using the tie breaker rules, determine the resident status of the corporations in the following two Cases:

**Case 1** Taxco is a company incorporated in Nova Scotia in 2017 to hold investments in other Canadian companies. Taxco never carried on business in Canada. All the shareholders and members of the board of directors are residents of the U.S. All board of directors meetings are held in the U.S.

**Case 2** Junkco is a company incorporated in Delaware in 2018. The majority of the members of the board of directors, however, reside in Montreal, where all board of directors meetings take place. Junkco does not carry on any business in Canada.

**SOLUTIONS available in print and online Study Guide.**

**We suggest you work Self Study Problems One-8 and 9 at this point.**

### Residence Of Trusts

1-130. The residence of a trust can only be determined by examining the circumstances involved in each case. In general, however, Income Tax Folio S6-F1-C1, *Residence Of A Trust Or Estate*, indicates that, similar to the case for corporations, a trust resides where the central management and control of the trust actually takes place.

1-131. Usually the management and control of the trust rests with, and is exercised by, the trustee, executor, liquidator, administrator, heir or other legal representative of the trust. However, the residence of the trustee does not always determine the residence of a trust. For example, if trustees reside in different jurisdictions, the trust will reside where the more substantial central management and control actually takes place.

1-132. In addition, if a substantial portion of the central management and control of the trust rests with someone other than the trustee, such as the settlor or the beneficiaries of the trust, the actions of these other persons must also be considered. It is where the central management and control is factually exercised that will determine the residence of the trust.

## Alternative Concepts Of Income

### The Economist's View

1-133. In the past, economists have viewed income as being limited to rents, profits, and wages. In general, capital gains, gratuitous receipts, and other such increases in net worth were not included. In this context, most economists perceived income to be a net concept. That is, income is equal to revenues, less any related expenses.

1-134. In more recent times, the economist's concept of income has moved in the direction of including measures of net worth or capital maintenance. The oft cited quotation "Income is the amount that can be spent during the period and still be as well off at the end of the period as at the beginning." is perhaps as good a description of the current concept as any available.

1-135. This broader concept of income is based on the idea that income should include all increases in net economic power that occur during the relevant measurement period.

### The Accountant's View

1-136. What we currently view as Net Income from an accounting point of view is the result of applying a fairly flexible group of rules that are referred to as generally accepted accounting principles (GAAP). In general, Net Income is determined by establishing the amount of revenue on the basis of point of sale revenue recognition. Then, by using a variety of cash flows, accruals, and allocations, the cost of assets used up in producing these revenues is matched against these revenues, with this total deducted to produce the accounting Net Income for the period.

1-137. If this same process is viewed from the perspective of the Balance Sheet, Net Income is measured as the increase in net assets for the period under consideration, plus any distributions that were made to the owners of the business during that period.

1-138. The current accounting model continues to value many assets at historical cost and records changes in value only when supported by an arm's length transaction. This means that many of the increases in wealth that would be included in the economist's concept of income would not be included in accounting Net Income.

1-139. However, the gap between the two approaches is gradually being narrowed as accounting standard setters show an increased willingness to incorporate fair value measurement into their pronouncements, both with respect to Balance Sheet values and with respect to inclusions in Net Income.

### The Income Tax Act View

1-140. As was the case with the determination of accounting income, the *Income Tax Act* uses a complex set of rules to arrive at a figure that we will refer to as Net Income For Tax Purposes. While tax references often refer to this figure simply as Net Income, we will use the lengthier designation in order to distinguish this figure from accounting Net Income.

1-141. Net Income For Tax Purposes is made up of several different types of income and, in addition, these different types of income must be combined using what tax practitioners refer to as an ordering rule. While the detailed computation of Net Income For Tax Purposes will occupy us through most of the first half of this text, we will provide a general discussion of its various components, as well as the ordering rule for combining these components, in the next section of this Chapter.

## Net Income For Tax Purposes

### Structure

1-142. The procedures for determining Net Income For Tax Purposes are specified in Division B of the *Income Tax Act*. In fact, this figure is sometimes referred to in tax literature as Division B Income. Once Net Income For Tax Purposes has been established, the items specified in Division C of the *Income Tax Act* are subtracted to determine Taxable Income. This Taxable Income figure provides the basis for calculating the federal income tax that is payable by individuals, corporations, and trusts that are resident in Canada.

1-143. Net Income For Tax Purposes is made up of four basic types of income, each of which requires a separate calculation of a net amount. Each net calculation is based on a group of inclusions and deductions that are specific to that type of income. For example, net employment income is made up of inclusions for items such as wages or salaries received, along with deductions for items such as union dues and the costs of required travel. Note that if an individual had business income deductions in excess of business income inclusions, this excess could not be applied directly in the calculation of net employment income.

1-144. In addition to the net calculations required for the four types of income, Net Income For Tax Purposes includes a group of other inclusions that do not fit in the four basic income categories, as well as a group of other deductions that are not related to the major categories of income.

### Components

1-145. The four types of income that are included as components of Net Income For Tax Purposes can be described as follows:

> **Net Employment Income (Loss)** Net employment income is made up of inclusions related to the activities of individuals who are serving as employees, less deductions related to that activity. These inclusions and deductions are specified in Division B, subdivision a, of the *Income Tax Act*. While it is possible to have a negative amount (employment loss), this would be fairly unusual. Note that, unlike the situation with other types of income, only individuals can earn employment income.
>
> **Net Business Income (Loss)** Net business income is made up of inclusions related to carrying on a business, less deductions related to that activity. These inclusions and deductions are specified in Division B, subdivision b, of the *Income Tax Act*. The business income rules are generally the same for individuals, corporations, and trusts.
>
> **Net Property Income (Loss)** Net property income is made up of inclusions related to the holding of property, less deductions related to holding such property. Examples of property income would include interest received on debt securities, dividends received on equity securities, and lease payments received on rental property. Note that, as the term is used in tax work, property income does not include capital gains or capital losses.

As was the case with net business income, inclusions and deductions related to property income are covered in Division B, subdivision b, of the *Income Tax Act*. While there are some differences in the rules for determining property income and those for determining business income, the calculations are sufficiently similar that they are included in a single subdivision. Like business income, property income can be earned by individuals, corporations, and trusts.

**Capital Gains and Capital Losses** Capital gains and losses arise when an asset that has been used to produce business or property income is sold. The inclusions and deductions related to this type of income are specified in Division B, subdivision c, of the *Income Tax Act*. As was true with business and property income, capital gains and losses can arise on dispositions by individuals, corporations, and trusts.

As you may already be aware, in Canada only one-half of capital gains are taxed and only one-half of capital losses are deductible. This has created the need for the use of special terminology. More specifically:

- The term "**taxable** capital gain" is used when referring to the taxable **one-half** of a capital gain. When the term capital gain (without the taxable) is used, it is a reference to 100 percent of the gain.
- The term "**allowable** capital loss" is used when referring to the deductible **one-half** of a capital loss. When the term capital loss (without the allowable) is used, it is a reference to 100 percent of the loss.

Unlike employment, business, and property losses, a net allowable capital loss (allowable capital losses in excess of taxable capital gains) cannot be deducted against any other type of income. This will be explained in more detail in the next section.

1-146. The remaining two components of Net Income For Tax Purposes can be described as follows:

**Other Sources Of Income** There are some additional sources of income that do not fit into any of the basic categories of income. These inclusions, which are largely applicable to individual taxpayers, are specified in Division B, subdivision d, of the *Income Tax Act*. Examples of these subdivision d inclusions would be pension income received, spousal support received, and social assistance payments received.

**Other Deductions From Income** Similar to the situation with inclusions, there are some deductions that do not relate to any of the basic income categories. These deductions, which are again largely related to individuals, are specified in Division B, subdivision e of the *Income Tax Act*. Examples of these subdivision e deductions include spousal support paid, child care costs, moving expenses, and RRSP contributions.

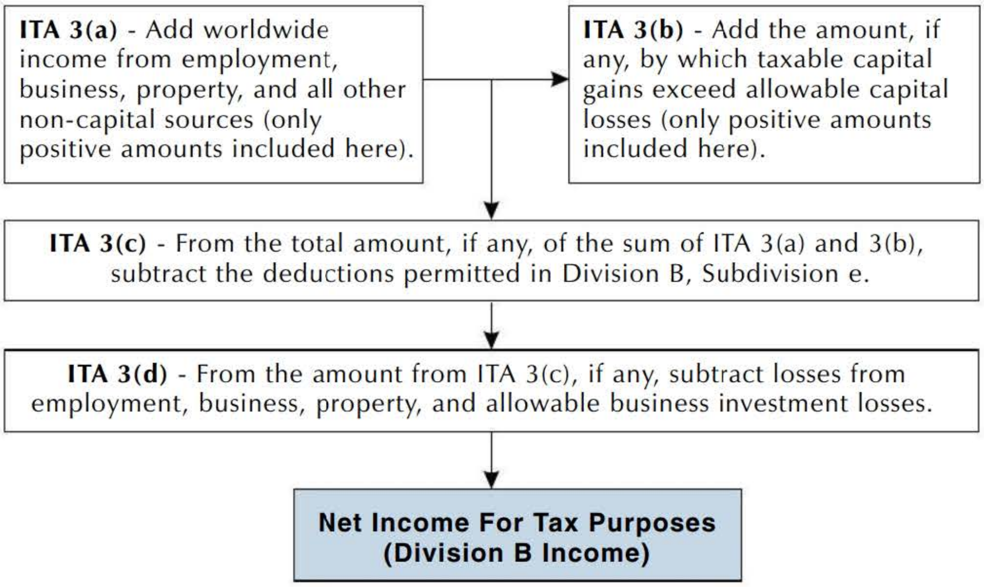
1-147. As a final point here, we would note that, if an amount received does not fall into one of these categories, it is not part of Net Income For Tax Purposes and, in general, it would not be subject to federal income tax. Examples of this would include lottery winnings, amounts inherited, and gambling profits. An "exception" to gambling profits being non-taxable could arise if the CRA concluded that an individual's gambling activities were so extensive that the individual was carrying on a gambling business.

## Combining The Components - ITA Section 3

### *Ordering Rules*

1-148. In the previous section, we noted that four types of income are included in Net Income For Tax Purposes, along with two other components which deal with miscellaneous inclusions and miscellaneous deductions. While it would be possible to simply add up these figures, this is not the approach that is required by the *Income Tax Act*. Section 3 of the *Income Tax Act* requires that these various components be combined in a very specific manner.

**Figure 1 - 3**
**Calculation Of Net Income For Tax Purposes**




1-149. This type of Section is referred to in tax work as an ordering rule and, while we will encounter several other such rules in the course of this text, we are concerned here with Section 3 which is the ordering rule for combining the various components of Net Income For Tax Purposes. This rule is applied to individuals, corporations and trusts.

1-150. While some of the ideas involved in applying this formula will not be fully explained until later in the text, it is useful at this stage to provide the basic structure of this formula in order to enhance your understanding of how the material on the various components of Net Income For Tax Purposes is organized.

1-151. The Section 3 rules are made up of four basic paragraphs, ITA 3(a), 3(b), 3(c), and 3(d). A discussion of each of these paragraphs follows. In addition, the ITA 3 rules are presented graphically in Figure 1-3.

### *ITA 3(a) Sources Of Income*

1-152. The ordering process begins in ITA 3(a) with the addition of all **Positive** sources of income other than taxable capital gains. This includes positive amounts of employment income, business income, property income, and other miscellaneous inclusions from Subdivision d of Division B.

1-153. Note that, while the individual components of this total are net amounts (e.g., employment income is made up of inclusions, net of deductions), the total is not a net calculation. For example, a business loss would not be deducted against a positive employment income under ITA 3(a). Rather, such losses would be deducted at a later point in the calculation of Net Income For Tax Purposes.

### *ITA 3(b) Net Taxable Capital Gains*

1-154. To the total determined in ITA 3(a), ITA 3(b) requires that you "determine the amount, if any, by which" taxable capital gains exceed allowable capital losses. The phrase "if any" is commonly used in tax legislation to indicate that negative amounts are ignored.

1-155. It is of particular importance here, since the fact that ITA 3(b) cannot be negative establishes the very important rule that the current year's allowable capital losses can only be deducted to the extent of taxable capital gains that have been recognized in the calculation of Net Income For Tax Purposes for the current year.

**EXAMPLE** During the current year, an individual has dispositions that result in taxable capital gains of $12,000 and allowable capital losses of $15,000.

**ANALYSIS** As there is no excess of taxable capital gains over allowable capital losses, the amount that will be added under ITA 3(b) will be nil.

1-156. The $3,000 excess of allowable capital losses over taxable capital gains does not disappear. As is explained in detail in Chapters 4 and 11, current year allowable capital losses that are in excess of current year taxable capital gains can be deducted in the calculation of Taxable Income in past or future years. Note, however, that this carry over allowable capital loss deduction is limited to the amount of net taxable capital gains that are included in the Net Income For Tax Purposes of the carry over year.

1-157. Unused allowable capital losses can be carried back to any of the preceding three taxation years. This will result in an amended Tax Payable for that year and a claim for a refund. If there are not sufficient taxable capital gains in the three preceding years to absorb the unused losses, they can then be carried forward to any subsequent taxation year. In a subsequent year, they will be deducted in the calculation of that year's Taxable Income, which will reduce the taxes that will have to be paid in that year.

**EXAMPLE** During 2019, an individual has a Net Income For Tax Purposes of $100,000, made up of $85,000 in net employment income and $15,000 in net taxable capital gains. This individual has an allowable capital loss carry forward, technically known as a net capital loss carry forward, from 2018 of $25,000. He has had no taxable capital gains in the preceding 3 years.

**ANALYSIS** The individual's Net Income For Tax Purposes and Taxable Income would be calculated as follows:

| | |
|---|---|
| ITA 3(a) Employment Income | $ 85,000 |
| ITA 3(b) Net Taxable Capital Gains | 15,000 |
| Net Income For Tax Purposes | $100,000 |
| Net Capital Loss Carry Forward (Note) | ( 15,000) |
| Taxable Income | $ 85,000 |

**Note** The net capital loss carry forward deduction is limited to $15,000, the amount of the net taxable capital gains for the year. The remaining $10,000 ($25,000 - $15,000) is carried forward to subsequent years.

### *ITA 3(c) Subdivision e Deductions*

1-158. The ITA 3(c) component of the calculation starts with the amount, if any, of the total from ITA 3(a) and ITA 3(b). Here again, the phrase "if any" indicates that only positive amounts will be used. If the total from ITA 3(a) and ITA 3(b) is nil, Net Income For Tax Purposes is nil and the calculation is complete.

1-159. Alternatively, if the total is positive, it is reduced by any Division B, Subdivision e deductions that are available. These deductions will be covered in detail in Chapters 9 and 10. Common examples of such deductions include:

- spousal support paid;
- moving expenses;
- child care costs; and
- RRSP contributions.

1-160. Note the importance of order here. ITA 3(c) requires that subdivision e amounts be deducted prior to business and property losses. This is important because subdivision e deductions are, in many cases, only deductible in the year to which they relate (e.g., if you cannot deduct spousal support in the current year, you cannot deduct it in a past or future year). In contrast, if you cannot use a business or property loss in the current year, it can be carried over to a past year or a future year.

### *ITA 3(d) Losses*

1-161. ITA 3(d) begins with any positive amount carried over from ITA 3(c). From this amount, any current year losses, other than allowable capital losses, will be deducted. This would include the deduction of any current year business losses, property losses, employment losses, and allowable business investment losses (allowable business investment losses are a special type of allowable capital loss that can be deducted against any type of income). Current period farm losses are also deductible here, subject to certain restrictions that are described in Chapter 6 (see the section on Income For Farmers).

## Loss Carry Overs

1-162. As we have noted, allowable capital losses that arise in the current year can only be deducted to the extent of taxable capital gains. Also as noted, other types of losses that arise in the current year can only be deducted to the extent that there is a positive total of other types of income and deductions after ITA 3(c). We have also mentioned the fact that these losses do not disappear — they can be carried back to claim a refund of taxes paid or forward to reduce future taxes payable.

1-163. Regardless of the type of loss, the carry back period is limited to the preceding 3 years. For example, a 2019 business loss can be deducted against amounts of Taxable Income that were recorded in 2016, 2017, or 2018.

1-164. In contrast, the limit on the carry forward period varies with the type of loss. In somewhat simplified form, the rules are as follows:

> **Carry Forward Of Allowable Capital Losses** Unused allowable capital losses can be carried forward and deducted in the determination of Taxable Income in any future taxation year, but only to the extent of the net taxable capital gains, if any, realized in the carry forward year.
>
> **Carry Forward Of Listed Personal Property Losses** Listed personal property is made up of specific types of personal use property (e.g. paintings or jewelry). Losses on such property can only be deducted against gains on listed personal property. While the carry back of unused amounts is the usual 3 years, the carry forward period is limited to 7 years. The deduction of any carry over is limited to gains on listed personal property in the carry over year.
>
> **Carry Forward Of Other Types Of Losses** Employment, business, and property losses that cannot be used in the year in which they arise, can be carried forward and deducted in the determination of Taxable Income in any of the next 20 years. With the exception of certain types of farm losses (a type of business loss), the carry forward amounts can be applied against any type of income.

1-165. The detailed rules for this carry forward process are fairly complex, involving a number of rules that are not described in this brief summary. These rules are given detailed consideration in Chapter 11.

## Net Income For Tax Purposes - Example

1-166. The following example provides an illustration of how the ITA 3 rules are applied.

**EXAMPLE** Jonathan Morley has the following income and loss components for the year:

| | |
|---|---|
| Net Employment Income | $17,000 |
| Business Loss (From Restaurant) | ( 21,000) |
| Net Property Income | 9,000 |
| Taxable Capital Gains | 14,000 |
| Allowable Capital Losses | ( 19,000) |
| Subdivision e Deductions (Spousal Support Paid) | ( 9,000) |

**ANALYSIS** Mr. Morley's Net Income For Tax Purposes would be calculated as follows:

| | | |
|---|---|---|
| **Income Under ITA 3(a):** | | |
| Net Employment Income | $17,000 | |
| Net Property Income | 9,000 | $26,000 |
| **Income Under ITA 3(b):** | | |
| Taxable Capital Gains | $14,000 | |
| Allowable Capital Losses | ( 19,000) | Nil |
| **Balance From ITA 3(a) And (b)** | | $26,000 |
| Subdivision e Deductions | | ( 9,000) |
| **Balance Under ITA 3(c)** | | $17,000 |
| Deduction Under ITA 3(d): | | |
| Business Loss | | ( 21,000) |
| **Net Income For Tax Purposes (Division B Income)** | | **Nil** |

1-167. Mr. Morley's Business Loss exceeds the amount calculated under ITA 3(c), resulting in a Net Income For Tax Purposes of nil. However, there would be a carry over of the unused business loss equal to $4,000 ($21,000 - $17,000), and of the unused allowable capital loss in the amount of $5,000 ($14,000 - $19,000).

### Exercise One - 15

**Subject:** Net Income For Tax Purposes

For the current year, Mr. Norris Blanton has net employment income of $42,000, a business loss of $15,000, taxable capital gains of $24,000, and Subdivision e deductions of $13,000. What is the amount of Mr. Blanton's Net Income For Tax Purposes for the current year?

### Exercise One - 16

**Subject:** Net Income For Tax Purposes

For the current year, Ms. Cheryl Stodard has interest income of $33,240, taxable capital gains of $24,750, allowable capital losses of $19,500, and a net rental loss of $48,970. What is the amount of Ms. Stodard's Net Income For Tax Purposes for the current year? Indicate the amount and type of any loss carry overs that would be available at the end of the current year.

**SOLUTIONS available in print and online Study Guide.**

**Exercise One - 17**

**Subject:** Net Income For Tax Purposes

For the current year, Mrs. Marie Bergeron has net employment income of $42,680, taxable capital gains of $27,400, allowable capital losses of $33,280, Subdivision e deductions of $8,460, and a business loss of $26,326. What is the amount of Mrs. Bergeron's Net Income For Tax Purposes for the current year? Indicate the amount and type of any loss carry overs that would be available at the end of the current year.

**SOLUTION available in print and online Study Guide.**

**We suggest you work Self Study Problems One-10, 11 and 12 at this point.**

# Net Income To Taxable Income

1-168. Once we have determined the amount of Net Income For Tax Purposes, it must then be converted into Taxable Income by deducting the items specified in Division C of the *Income Tax Act*. This is, in fact, a fairly complex process that will be covered in detail in Chapters 4 and 11.

1-169. While we are deferring detailed coverage of this subject, it is useful as part of this overview for you to be aware of the major items that will be involved in the conversion of Net Income For Tax Purposes to Taxable Income. They are as follows:

- A deduction for losses carried over from other years.
- A deduction for social assistance and worker's compensation payments that have been included in Net Income For Tax Purposes.
- A deduction related to amounts of employment income resulting from the exercise or sale of stock options.
- A deduction related to capital gains on qualified property (the lifetime capital gains deduction).
- A deduction related to the costs of living in certain areas of the Canadian north.

# Principles Of Tax Planning

## Introduction

1-170. Throughout this text, there will be a great deal of emphasis on tax planning and, while many of the specific techniques that are involved can only be fully explained after the more detailed provisions of tax legislation have been covered, there are some basic tax planning principles that can be described at this point.

1-171. Our objective here is simply to provide a general understanding of the results that can be achieved through tax planning so that you will be able to recognize the goal of more specific tax planning techniques when they are examined. In addition, this general understanding should enable you to identify other opportunities for tax planning as you become more familiar with this material.

1-172. The basic goals of tax planning can be summarized as follows:

- Tax avoidance or reduction.
- Tax deferral.
- Income splitting.

1-173. While these classifications can be used to describe the goals of all tax planning arrangements, such arrangements seldom involve a clear cut attempt to achieve only one of these goals. For example, the principal reason for making contributions to a Registered

Retirement Savings Plan is to defer taxes until later taxation years. However, such a deferral can result in the taxpayer avoiding some amount of taxes if he is taxed at a lower rate in those later years.

## Tax Avoidance Or Reduction

1-174. The most desirable result of tax planning is to permanently avoid the payment of some amount of tax. This very desirability is probably the most important explanation for the scarcity of such arrangements and, while the number of possibilities in this area is limited, they do exist.

1-175. An outstanding example of tax avoidance is the capital gains deduction that is available on the disposition of qualified farming or fishing property, and qualified small business corporation shares. For 2019, the deduction limit for dispositions of shares of qualified small business corporations is $866,912. There is an additional amount for farm or fishing properties of $133,088, providing a total of $1,000,000 for all such qualified properties. These capital gains can be received by an individual taxpayer on a completely tax free basis. For individuals in a position to enjoy the benefits of this provision, it is one of the best tax avoidance mechanisms available (see Chapter 11 for a detailed discussion of this provision).

1-176. Other forms of complete tax avoidance can be found in the employee benefits area, in that some types of benefits can be given to employees without being considered taxable. These would include an employer's contributions to disability and private health care insurance, and the provision of discounts to employees on products or services normally sold by the employer (see Chapter 3).

1-177. Additional opportunities in this area require more complex arrangements. Such arrangements involve the use of trusts and private corporations and cannot be described in a meaningful manner at this stage of the material.

## Tax Deferral

1-178. The basic concept behind tax planning arrangements involving the deferral of tax payments is the very simple idea that it is better to pay taxes later rather than sooner. This is related to the time value of money and also involves the possibility that some permanent avoidance of taxes may result from the taxpayer being taxed at a lower marginal income tax rate at the time the deferred amounts are brought into taxable income.

1-179. Such deferral arrangements may involve either the delayed recognition of certain types of income or, alternatively, accelerated recognition of deductions. As an example of delayed recognition of income, an employer can provide a benefit to an employee in the form of contributions to a registered pension plan. Such benefits will not be taxed in the year in which they are earned. Rather, they will be taxed at a later point in time when the employee begins to receive benefits from the registered pension plan.

1-180. As an example of expense acceleration, the ownership of a rental property may allow the owner to deduct its capital cost at a rate that is usually in excess of any decline in the physical condition or economic worth of the building. While this excess deduction will normally be added back to the taxpayer's income when the building is sold, the payment of taxes on some part of the rental income from the property has been deferred.

1-181. Deferral arrangements are available in a number of different situations and currently represent one of the more prevalent forms of tax planning.

## Income Splitting

### *General Idea*

1-182. Progressive rates are built into Canadian federal income tax legislation. This means that, in general, the taxes payable on a given amount of taxable income will be greater if that amount accrues to one taxpayer, than would be the case if that same total amount of taxable income is split between two or more people. While not technically a form of income splitting,

the same effect can be achieved by having a given sum of taxable income taxed in the hands of an individual in a low tax bracket rather than an individual in a high tax bracket.

1-183. This does not mean that it would be advantageous to give part of your income away to perfect strangers. What it does mean is that, within a family or other related group, it is desirable to have the group's aggregate taxable income allocated as evenly as possible among the members of the group.

### Example

1-184. The tax savings that can be achieved through income splitting are among the most dramatic examples of the effectiveness of tax planning. For example, if Mr. Jordan had taxable income of $841,484 (this is four times $210,371, the bottom threshold of the highest federal tax bracket in 2019 of 33 percent), his basic federal tax payable in 2019 would be $256,986 (this simplified calculation does not take into consideration the various tax credits that would be available to Mr. Jordan).

1-185. Alternatively, if Mr. Jordan was married and the $841,484 could be split on the basis of $420,742 to him and $420,742 to his wife, the federal taxes payable would total $236,282 [(2)($118,141)], a savings of $20,704 ($256,986 - $236,282).

1-186. If we carry this one step further and assume that Mr. Jordan is married and has two adult children, and that the $841,484 in taxable income can be allocated on the basis of $210,371 to each individual, the total federal taxes payable will be reduced to $194,876 [(4)($48,719)]. This represents a savings at the federal level of $62,110 ($256,986 - $194,876) when compared to the amount of taxes that would have been paid if Mr. Jordan alone had been taxed on the entire $841,484.

1-187. When we add provincial effects, the potential savings could be close to $100,000, a substantial reduction on income of $841,484. Making this savings even more impressive is the fact that it is not a one shot phenomena but, rather, a savings that could occur in each year that the income splitting plan is in effect.

**Note To Students** You will learn how to calculate the tax payable amounts shown in the preceding paragraphs in Chapter 4 of the text.

### Problems With Income Splitting

1-188. While income splitting can be one of the most powerful planning tools available to taxpayers, there are several problems associated with implementing such arrangements:

- Splitting income with children often involves losing control over assets, a process that is emotionally difficult for some individuals.
- Splitting income involves decisions as to which family members are worthy of receiving benefits and how much those benefits should be.
- The 2018 expansion of the applicability of the Tax On Split Income (TOSI), a high rate tax assessed on certain types of income received by related individuals, can make income splitting very difficult in some situations. This tax is described in Chapter 11.

## Exercise One - 18

**Subject:** Tax Planning

Mr. Stephen Chung, a successful flamenco dancer, has decided to make contributions to an RRSP in the name of his spouse, the mother of his twelve children, rather than making contributions to his own plan. What type of tax planning is involved in this decision? Explain your conclusion.

**SOLUTION available in print and online Study Guide.**

**Exercise One - 19**

**Subject:** Tax Planning

Mr. Green's employer pays all of the premiums on a private dental plan that covers Mr. Green and his family. What type of tax planning is illustrated by this employee benefit? Explain your conclusion.

**SOLUTIONS available in print and online Study Guide.**

**Additional Supplementary Self Study Problems Are Available Online.**

## Abbreviations To Be Used

1-189. In our writing, we try to avoid using abbreviations because we believe that there is a tendency in accounting and tax writing to use so many of them that the material can become unreadable. However, in the tax area, some sources are so commonly cited that it is clearly inefficient to continue using their full description. As a result, in the remainder of this text, we will use the following abbreviations on a regular basis:

| Abbreviation | Meaning |
|---|---|
| CRA | Canada Revenue Agency |
| CCA | Capital Cost Allowance (see Chapter 5) |
| CCPC | Canadian Controlled Private Corporation |
| GAAP | Generally Accepted Accounting Principles |
| GST | Goods and Services Tax |
| HST | Harmonized Sales Tax |
| IC | Information Circular |
| IT | Interpretation Bulletin |
| ITA | Federal *Income Tax Act* |
| ITF S#-F#-C# | A Chapter in an Income Tax Folio that is part of a Series |
| RPP | Registered Pension Plan |
| RRSP | Registered Retirement Savings Plan |
| TFSA | Tax Free Savings Account |
| TOSI | Tax On Split Income |
| UCC | Undepreciated Capital Cost (see Chapter 5) |

## Key Terms Used In This Chapter

1-190. The following is a list of the key terms used in this Chapter. These terms, and their meanings, are compiled in the Glossary Of Key Terms located at the back of the Study Guide.

Advance Tax Ruling
Allowable Capital Loss
Business Income
Capital Asset
Capital Gain/Loss
Capital Tax
Consumption Tax
Customs Duties
Deemed Resident
Division B Income
Dual Resident
Employment Income
Fiscal Period
Flat Tax System
Goods And Services Tax
GST
Harmonized Sales Tax (HST)
Head Tax
Income
Income Splitting
Income Tax
Income Tax Application Rules
Income Tax Folios
Income Tax Regulations
Income Tax Technical News
Individual
Information Circulars
Interpretation Bulletins
Net Income For Tax Purposes
Non-Resident
Ordering Rule
Part Year Resident
Person
Progressive Tax System
Property Income
Property Tax
Qualitative Characteristics
Regressive Tax System
Residential Ties
Resident
Sojourner
Tariffs
Tax Base
Tax Deferral
Tax Expenditure
Tax Incidence
Tax Planning
Taxable Canadian Property
Taxable Capital Gain
Taxable Entity
Taxable Income
Taxation Year
Tie Breaker Rules
Transfer Tax
Value Added Tax

## References

1-191. For more detailed study of the material in this Chapter, we would refer you to the following:

| | |
|---|---|
| ITA 2(1) | Tax Payable By Persons Resident In Canada |
| ITA 2(3) | Tax Payable By Non-Resident Persons |
| ITA 3 | Income For Taxation Year |
| ITA 114 | Individual Resident In Canada For Only Part Of Year |
| ITA 115 | Non-Resident's Taxable Income In Canada |
| ITA 116 | Disposition By Non-Resident Person Of Certain Property |
| ITA 118.91 | Part-Year Residents |
| ITA 118.94 | Tax Payable By Non-Resident (Tax Credits) |
| ITA 248(1) | Definitions (Taxable Canadian Property) |
| ITA 249 | Definition Of "Taxation Year" |
| ITA 250(1) | Person Deemed Resident |
| S5-F1-C1 | Determining An Individual's Residency Status |
| S6-F1-C1 | Residence of a Trust or Estate |
| IT-168R3 | Athletes And Players Employed By Football, Hockey And Similar Clubs |
| IT-420R3 | Non-Residents - Income Earned In Canada |

# Problems For Self Study (Online)

To provide practice in problem solving, there are Self Study and Supplementary Self Study problems available on MyLab Accounting.

Within the text we have provided an indication of when it would be appropriate to work each Self Study problem. The detailed solutions for Self Study problems can be found in the print and online Study Guide.

We provide the Supplementary Self Study problems for those who would like additional practice in problem solving. The detailed solutions for the Supplementary Self Study problems are available online, not in the Study Guide.

The .PDF file "Self Study Problems for Volume 1" on MyLab contains the following for Chapter 1:

- 12 Self Study problems,
- 5 Supplementary Self Study problems, and
- detailed solutions for the Supplementary Self Study problems.

# Assignment Problems

(The solutions to these problems are only available in the solutions manual that has been provided to your instructor.)

### *Assignment Problem One - 1*

***(Application Of General Tax Principles)***

Many of the provisions of the *Income Tax Act* are written in very general terms. For example, ITA 18 lists a number of general characteristics that must apply before a particular expense can be deducted in the computation of business income.

**Required**: Indicate the situations in which such generally worded provisions of the *Income Tax Act* will be overridden.

### *Assignment Problem One - 2*

***(Conflicting Objectives)***

The tax systems of various countries are designed to meet a variety of objectives. In addition to raising revenues, we call on our tax systems to provide fairness, to have the characteristic of simplicity, to meet social or economic goals, to balance regional disparities, and to be competitive on an international basis. While it would be a fairly simple matter to design a system that would meet any single one of these objectives, we frequently encounter conflicts when we attempt to create a system that meets several of these objectives.

**Required**: Discuss the possible conflicts that can arise when a tax system is designed to meet more than a single objective.

### *Assignment Problem One - 3*

***(Application Of Qualitative Characteristics)***

In the United States, President Trump has reduced the tax rate on corporations from 35 percent to 21 percent.

**Required:** Evaluate the reduction of the tax rate on corporations in the United States on the basis of the qualitative characteristics of tax systems that are listed in your text.

### Assignment Problem One - 4

#### (Application Of Qualitative Characteristics)

The city of Elysium is located on an island in the Nirvana River. Because of its very desirable climate, it has attracted wealthy immigrants from all over the world. These immigrants have either built palatial new homes on the river waterfront, or moved into luxurious residences, largely in high-rise buildings in the city's core.

In general, real estate values on the island are among the highest in the world. In order to protect their extremely orderly environment, the residents have prevented the development of any reasonably priced housing. To help maintain this environment the city has a large, well trained security force.

The economic activity on the island consists of financial services, haute cuisine restaurants, and retail shops which feature high-end products from all over the world. Because of the high real estate cost, staff for these operations must live off island and commute on a daily basis.

To accommodate residents of the island, the city operates a large heliport. This allows the residents of the island to quickly access a nearby airport where most maintain at least one private jet.

Until recently, the only other access to the island was via a city operated ferry. This service was provided free of charge by the city. While it was rarely used by the residents of Elysium, the staff of the various businesses on the island relied on it for access to their jobs.

Last year, the city completed a four lane bridge to access the island. In order to finance the tremendous cost of this project, there is a $10 toll for each trip across the bridge. To ensure that the bridge produces adequate revenues, the city has canceled the ferry service.

**Required:** Evaluate the $10 toll on the basis of the qualitative characteristics of tax systems that are listed in your text.

### Assignment Problem One - 5

#### (Residency After Departure From Canada)

Mr. Valone is a U.S. citizen. However, since obtaining permanent residence status in 2005, he has been employed on a full time basis in London, Ontario. His employer is a Canadian subsidiary of a multi-national corporation that operates in a number of different countries. The head office of the company is in the United States.

Mr. Valone has been very successful in his position with the Canadian subsidiary. Based on this, he has been offered a promotion which involves a significant increase in salary. However, this promotion is conditional on his moving to the company's head office in Philadelphia no later than March 1, 2019. Given the sizable increase in remuneration, Mr. Valone finds this offer too good to pass up.

As he is a U.S. citizen, he has no difficulty getting the appropriate documentation to establish his residency in the U.S. He relinquishes his Canadian driver's licence, as well as his provincial health care card. As required by his employer, he is at his desk in the new work location in the U.S. on March 1.

Mr. Valone and his spouse have two children who are attending a private school in London. The current semester at this school lasts until June 15, 2019. In order to provide continuity in their education, Mrs. Valone decides that she and children will remain in Canada until the current semester is finished. They depart on June 20, 2019.

The real estate market in London has been somewhat slow of late. As a consequence, the Valone's house is not sold until October 5, 2019.

**Required:** For purposes of assessing Canadian income taxes, determine when Mr. Valone ceased to be a Canadian resident and the portion of his annual income which would be assessed for Canadian taxes. Explain your conclusions.

### Assignment Problem One - 6

#### (Residency After Departure From Canada)

Mr. David Hamilton was a long-time resident of Canada. On January 13, 2016, he departed from Canada to work in Qatar. The work was done under a contract of employment with an American company that was operating in Qatar.

1. Mr. Hamilton did not obtain resident status in Qatar or in any other country. He did not have a postal address in Qatar.
2. Mr. Hamilton obtained a work permit in Qatar that was valid until August 13, 2019.
3. After the work permit expired, Mr. Hamilton had to leave Qatar. He subsequently returned several times to meet with friends and business associates there.
4. Mr. Hamilton's Canadian driver's licence expired in August, 2015 and was not renewed.
5. After taking intensive driving courses, Mr. Hamilton acquired a driver's licence in Qatar in December, 2016 that was valid for 5 years.
6. Mr. Hamilton gave up his Canadian health card in 2017.
7. Mr. Hamilton had two sons who remained in Canada. One of the sons, Harold, had significant health issues.
8. Mr. Hamilton kept a credit card, bank account, an RRSP and investments in Canada when he began work in Qatar.
9. Mr. Hamilton continued to hold a Canadian passport.
10. He visited Canada four times in 2016 and three times during 2017. Each visit was for 2 weeks. His visits were largely to see his sons and mother. The relationship with his wife was strained before he left for Qatar and deteriorated significantly afterwards. This led to their divorce in 2017. After his son Harold advised him to follow his dream of leaving Canada, he began the process of permanently leaving Canada. To this end, on July 1, 2017, he gave his share of the family home to his wife and closed all of his Canadian financial accounts. He paid regular support payments after the divorce occurred.
11. During his visits to Canada, he stayed in hotels and used rented vehicles.
12. In 2016, Mr. Hamilton's accountant filed a tax return for him as a resident of Canada.
13. Mr. Hamilton is well respected in his profession and considered to be a very responsible employee.

Despite filing a tax return in 2016 as a resident of Canada, Mr. Hamilton believes that he gave up his Canadian residency on January 13, 2016 and wishes to revise his 2016 tax return to reflect this.

**Required:** Determine whether Mr. Hamilton is a resident of Canada. If you conclude he is not, provide the date that he ceased to be a Canadian resident. Provide reasons for your conclusion.

### Assignment Problem One - 7

#### (Residency Of Individuals - 5 Cases)

For each of the following individuals, determine their residency status for the year ending December 31, 2019. In addition, indicate what components of their income would be subject to Part I taxation in Canada, either as a resident or a non-resident. Provide the basis for your conclusions. Your answer should not take into consideration the influence of International Tax Treaties.

**Case A** Gary Short is a Canadian citizen who has lived and worked in Calgary, Alberta all of his life. In January, 2019, he is offered a significant promotion if he will accept a position in Australia. On accepting this position, he establishes residency in that country on February 1. However, because his children wish to finish the school year in Canada, his children and his wife do not join him until June 30, 2019. Because of the poor real estate market in his Calgary neighbourhood, his former residence is rented out under a long term residential lease beginning July 1.

**Case B** Sarah Sloan is a U.S. citizen who lives in Detroit, Michigan. During 2019 she is employed five days per week in Windsor, Ontario. She commutes to Windor on a daily basis. Her 2019 salary is $86,000 (Canadian). In addition, she has $900 (Canadian) of interest on a savings account with a Detroit bank.

**Case C** Byron Long is a citizen of France. However, having established landed immigrant status in Canada, he has worked in this country for over 15 years. On the unexpected death of his spouse, he receives an insurance payment of $2 million. He decides to use a large part of this payment for an extensive round-the-world cruise. He arranges a two year leave of absence from his job and sails from Canada on July 1, 2019. He sells the family residence, but retains all of his Canadian banking and brokerage accounts.

**Case D** Hilda Stein is married to a member of the Canadian armed forces who is stationed in Germany during the year 2019. She is a German citizen and has never visited Canada. During 2019, because her husband is a member of the Canadian armed forces, she is not subject to taxation in Germany.

**Case E** Jessica Segal has always lived in Canada. She has been asked by her Canadian employer to spend part of 2019 starting on August 1 and all of 2020 and 2021, working in the company's Frankfurt office. Her employment contract requires her to return to Canada on January 5, 2022. Jessica sells her condo and furniture and reluctantly gives her beloved dog to her brother. She moves to Frankfurt in July, 2019.

### Assignment Problem One - 8

#### (Residency Of Corporations - 4 Cases)

Each of the following cases provides information about an individual corporation. For each case, indicate whether the corporation would be considered a Canadian resident for the current year. Explain your conclusions.

**Case A** The Allor Company was incorporated in North Dakota in 1999. Currently, however, the head office of the corporation is in Regina, Saskatchewan. As all of the directors of the corporation are residents of this Canadian city, all of the meetings of the board of directors are held in Regina.

**Case B** Kodar Ltd. was incorporated in Canada in 2005. However, as its directors have come to hate Canadian winters, they have all moved permanently to the southern United States. Because of this, they hold all of their Board of Directors meetings in Phoenix, Arizona.

**Case C** The Karlos Company was incorporated in Minnesota in 1998. The two directors lived in Winnipeg, Manitoba and for several years, all of the Board of Directors and shareholders meetings were held in Winnipeg, Manitoba. In early 2005, the directors were replaced by residents of St. Paul, Minnesota. After this, all of the Board of Directors and shareholders meetings were held in St. Paul.

**Case D** Bradlee Inc. was incorporated in Canada in 1961. While it operated in Canada for a number of years, all of its operations, management and directors relocated to the United States in 2008.

## Assignment Problem One - 9

### (Residency Of Individuals And Corporations)

Pertinent facts are given for a different individual or corporation in each of the Parts of this problem. For each Part, indicate whether or not this individual or corporation would be considered a Canadian resident for income tax purposes during the 2019. Briefly explain your conclusion.

A. Brian Palm was born in Kanata, Ontario. In January, 2019, after a record snowfall had paralyzed the area, Brian concluded he was not prepared to continue dealing with Ontario winters. He wound up his Canadian affairs and, on July 31, 2019, he moved to Palm Beach Florida. He has vowed to never set foot in Canada again.

B. Gunter is married to Rachel, who is a member of the Canadian armed forces serving in Germany. Except for a brief visit to Rachel's home town of Dartmouth, Nova Scotia, Gunter has never been to Canada. Gunter is exempt from taxation in Germany because he is the spouse of a deemed resident of Canada.

C. Sarah is a U.S. citizen living in Bloomfield Hills, Michigan. Most of her personal belongings are located in her parent's home in that city. However, throughout 2019, she has spent at least four days of every week living with her boyfriend in Windsor, Ontario. They plan to be married at some future date.

D. Martha is a U.S. citizen who, until 2018, had lived and worked in Canada as a landed immigrant for over 20 years. After winning $1.2 million playing black jack at the Montreal Casino, on August 28, 2018, she left Canada on a 2 year pleasure trip that will take her to virtually every country in the world. Her husband and children, all Canadian citizens, continue to live at the family home in Laval, Quebec.

E. Bronson Inc. was incorporated in Ontario in 1962. Until 1993, its only director resided in that province. In that year, the director was replaced by an individual resident in Corning, New York.

F. Ubex Ltd. was incorporated in Delaware in 1985. Until 1998, all of the directors of the corporation lived in Moncton, New Brunswick. During this period, the Board of Directors meetings were held in that city. Beginning in 1999, all of the directors have been residents of Green Bay, Wisconsin and all of the Board of Directors meetings have been held in Wilmington, Delaware.

### Assignment Problem One - 10

#### (Residency/Dual Residency - Individuals)

Determine the residency status of the individuals in the following Cases. Use the tie-breaker rules found in the Canada/U.S. tax treaty where appropriate.

**Case A** Ty Breaker is a citizen of the United States. He is a professional athlete, a successful entrepreneur and very single. During 2019, he plays for a Canadian soccer team and, as a consequence, he spends 194 days in Canada. Because of his extensive travel, he stores his few personal items in his mother's basement and lives in short term rentals of hotel suites in both Canada and the U.S. As he owns corporations in both countries, he has office space in both Canada and the U.S. In previous years, Ty has played for a U.S. soccer team and has spent less than 100 days per year in Canada.

**Case B** Jordan Marsh is a U.S. citizen who does construction work as an independent contractor. He has a home in Kalispell, Montana which he has owned for many years. As work has been slow in that city in recent years, he decides to temporarily move to Lethbridge after hearing work is plentiful there. He moves on March 31, 2019. He does not sell his Kalispell residence as his brother needs a temporary home while he renovates. Jordan lives in a Lethbridge hotel until February 12, 2020. By this time he has realized that the work situation is worse in Lethbridge than it was in Kalispell. Given this, he returns to Kalispell.

### Assignment Problem One - 11

#### (Alternative Views Of Income)

Distinguish between the accountant's, the economist's, and the *Income Tax Act* views of income.

### Assignment Problem One - 12

#### (Net Income For Tax Purposes - Two Cases)

Karla Gomez is a Canadian resident who lives in Toronto. In the following two Cases, different assumptions are made with respect to the amounts and types of income she will include in her tax return for the current year. Information is also provided on the deductions that will be available to her for the year.

**Case One** Karla had net employment income of $62,350. Unfortunately, her unincorporated flower shop suffered a net business loss of $115,600. In contrast, she had a very good year in the stock market, realizing the following gains and losses:

| | |
|---|---|
| Capital Gains | $97,650 |
| Capital Losses | 5,430 |

Also during the current year, Karla made deductible contributions of $4,560 to her RRSP.

**Case Two** Karla had net employment income during the year of $45,600, as well as net business income of $27,310 and a net rental loss of $4,600. As part of a divorce agreement from a previous year, Karla paid spousal support of $600 per month to her former common-law partner, Lucretia Smart for the entire year. She realized the following results in the stock market during the year:

| | |
|---|---|
| Capital Gains | $31,620 |
| Capital Losses | 41,650 |

While Karla does not gamble on a regular basis, she enjoys the ambiance of the local casino. Given this, two or three times a year, she spends an evening dining and gambling with friends there. In March of this year, she got very lucky, winning $46,000 by hitting a slot machine jackpot.

**Required**: For each Case, calculate Karla's Net Income For Tax Purposes (Division B income) for the current year. Indicate the amount and type of any loss carry overs that would be available at the end of the year.

## Assignment Problem One - 13

### (Net Income For Tax Purposes - Four Cases)

The following four Cases make different assumptions with respect to the amounts of income and deductions of Frank Denham for the current year:

| | Case A | Case B | Case C | Case D |
|---|---|---|---|---|
| Employment Income | $58,200 | $82,600 | $46,700 | $33,400 |
| Income (Loss) From Business | ( 12,300) | ( 8,400) | ( 62,300) | ( 46,200) |
| Rental Income (Loss) | 5,400 | 12,200 | 2,600 | ( 18,300) |
| Taxable Capital Gains | 31,600 | 15,600 | 11,600 | 23,100 |
| Allowable Capital Losses | ( 12,400) | ( 23,400) | ( 10,700) | ( 24,700) |
| Subdivision e Deductions | ( 4,100) | ( 5,400) | ( 11,600) | ( 5,600) |

**Required:** For each Case, calculate Mr. Denham's Net Income For Tax Purposes (Division B income). Indicate the amount and type of any loss carry overs that would be available at the end of the current year, or state that no carry overs are available.

# CHAPTER 2

# Procedures And Administration

## Introduction

2-1. This Chapter begins with a brief overview of the administration of the Canada Revenue Agency (CRA). This is followed by a description of filing and tax payment procedures applicable to individuals, corporations, and trusts.

2-2. This material on filing and tax payment procedures will be followed by a description of the assessment and reassessment process, including the various avenues that can be followed in appealing unfavourable assessments. Attention will also be given to issues related to tax avoidance and tax evasion, collection and enforcement procedures, and taxpayer relief provisions.

## Administration Of The Department

2-3. The CRA has the responsibility for carrying out the tax policies that are enacted by Parliament. In carrying out these policies, the chief executive officer of the CRA is the Commissioner of Revenue. The duties of the Minister of National Revenue, as well as those of the Commissioner of Revenue, are described in the *Act* as follows:

> **ITA 220(1)** The Minister shall administer and enforce this Act and the Commissioner of Revenue may exercise all the powers and perform the duties of the Minister under this Act.

2-4. The Minister of National Revenue is responsible for the CRA and is accountable to Parliament for all of its activities, including the administration and enforcement of program legislation such as the *Income Tax Act* and the *Excise Tax Act*. The Minister has the authority to ensure that the CRA operates within the overall government framework and treats its clients with fairness, integrity, and consistency.

2-5. The CRA has a Board of Management consisting of 15 members appointed by the Governor in Council, 11 of whom have been nominated by the provinces and territories. The Board has the responsibility of overseeing the management of the CRA, including the development of the Corporate Business Plan, and the management of policies related to resources, services, property, personnel, and contracts. The Commissioner of the CRA, who is a member of the CRA Board, is responsible for the CRA's day-to-day operations.

2-6. Unlike the boards of Crown corporations, the CRA Board is not involved in all the activities of the CRA. In particular, the CRA Board has no authority in the administration and

enforcement of legislation, which includes the *Income Tax Act* and the *Excise Tax Act*, for which the CRA remains fully accountable to the Minister of National Revenue. In addition, the CRA Board is denied access to confidential client information.

2-7. Following the ministerial mandate found in ITA 220(1), ITA 221(1) provides that the Governor in Council has the power to make Income Tax Regulations for various specific purposes or for the purpose of carrying out other provisions of the *Income Tax Act*. Unlike the provisions of the *Income Tax Act*, these Regulations may be passed by Order-In-Council without ratification by Parliament. They generally become effective when they are published in the Canada Gazette.

# Returns And Payments - Individuals

## Requirement To File - ITA 150

2-8. ITA 150(1) is a general rule that requires all persons (individuals, corporations, and trusts) to file a tax return. Although ITA 150(1.1)(b) exempts individuals from filing tax returns except where certain conditions are met, there are still other provisions in the *Income Tax Act* that require returns to be filed. The CRA website lists many reasons why an individual would be required to file an individual tax return (Form T1), the most common reasons being if, in the year, the individual:

- has Tax Payable;
- is requested by the CRA to file a tax return;
- has disposed of a capital property, or realized a taxable capital gain;
- and his spouse or common-law partner have elected to split pension income; or
- has to contribute to the Canada Pension Plan or pay Employment Insurance premiums.

2-9. In addition to these requirements for residents, non-resident individuals must generally file a T1 tax return if, during the year, they have a taxable capital gain or dispose of a Taxable Canadian Property (See Chapter 20, International Issues In Taxation for more details.)

2-10. Even when there is no requirement to file, if an individual is entitled to a refund, it will only be available if a return is filed. Further, it is beneficial for others to file, especially low income taxpayers, in order to be eligible for income-based benefits such as the Canada Child Benefit, the GST credit and the Guaranteed Income Supplement. If they fail to file, they will not receive these amounts, even if they qualify.

2-11. Individuals can either file a paper form or, alternatively, use an electronic filing method. The advantage of electronic filing for the taxpayer, particularly if he is entitled to a refund, is that the return will be processed more quickly. For the CRA, electronic filing eliminates the possibility of errors in the process of transferring information from paper forms to their electronic records. While supporting documents (e.g., a charitable donation receipt) cannot be included with an electronic filing, the CRA has the right to request that such receipts be provided. Such requests are fairly common, particularly when large amounts are involved.

2-12. The CRA website has detailed coverage of the two alternatives for electronic filing. Both EFILE and NETFILE are automated transmission services that permit the filing of tax returns online. The main difference between them can be described as follows:

> **NETFILE** allows a taxpayer to file their own personal income tax return directly to the CRA online through the use of a CRA certified tax software program. It is intended for use by those who prepare their own tax returns. This system can be used by almost all Canadian resident individuals.
>
> **EFILE** allows tax preparation service providers who are registered with the CRA to file tax returns for clients online. It is designed for those who prepare and file tax returns for clients. The NETFILE system cannot be used to file returns for clients.

2-13. CRA's filing statistics for the 2017 personal tax filing season covering the period from February 12, 2018 to September 9, 2018 are shown in the following table. There has been a

significant decline in the percentage of taxpayers using paper filing over the 5 years.

| Filed During | Electronically Filed | Paper Filed | Total T1 Returns |
|---|---|---|---|
| 2018 | 25,245,885 (88%) | 3,627,413 (12%) | 28,873,298 |
| 2017 | 24,217,401 (86%) | 3,869,830 (14%) | 28,087,231 |
| 2016 | 23,507,132 (85%) | 4,177,253 (15%) | 27,684,385 |
| 2015 | 23,383,313 (81%) | 5,397,643 (19%) | 28,780,956 |
| 2014 | 21,936,593 (78%) | 6,162,087 (22%) | 28,296,680 |

2-14. Of the total 2017 returns electronically filed during 2018, 16,625,029 were filed under the EFILE program, while 8,573,660 were filed using NETFILE.

## Due Date For Individual Returns

### *General Rule*

2-15. As noted in Chapter 1, individuals must use the calendar year as their taxation year. This means that for every individual, the taxation year ends on December 31. Given this, ITA 150(1)(d)(i) indicates that, in general, individuals must file their tax return for a particular year on or before April 30 of the following year. Although the filing due date is extended to the next business day if the due date falls on a weekend, we will use April 30 (or June 15 if applicable as explained in the following material) as the due date in our examples and problems.

### *Individuals Who Are Partners Or Proprietors*

2-16. Recognizing that individuals who are involved in an unincorporated business may need more time to determine their income for a taxation year, the *Income Tax Act* provides a deferral of the filing deadline. If an individual, and/or his cohabiting spouse or common-law partner, carried on a business during the year, ITA 150(1)(d)(ii) extends the due date for filing to June 15 of the calendar year following the relevant taxation year.

2-17. An interesting feature of this provision is that, while the return does not have to be filed until June 15, payment of all taxes owing is required by the usual date of April 30. Any amounts that are not paid by April 30 will be assessed interest until the outstanding balance is paid. The relevant interest rate is described later in this Chapter.

**Exercise Two - 1**

**Subject:** Individual Tax Payment Date

Brandon Katarski's 2019 Net Income includes business income. When is his 2019 tax return due? By what date must his 2019 tax liability be paid in order to avoid the assessment of interest on amounts due?

**SOLUTION available in print and online Study Guide.**

### *Deceased Taxpayers*

2-18. As will be discussed in Chapter 9, there are many tax related complications that arise when an individual dies. In order to provide the deceased individual's representatives with sufficient time to deal with these complications, the *Act* indicates the following:

> **ITA 150(1)(b)** ... in the case of an individual who dies after October of the year and before the day that would be the individual's filing due date for the year if the individual had not died, by the individual's legal representatives on or before the day that is the later of the day on or before which the return would otherwise be required to be filed and the day that is 6 months after the day of death;

2-19. For an individual whose filing due date is April 30, this provision means that if death occurs between November 1 of the previous year and April 30 of the current year, the return for the previous year does not have to be filed until six months after the date of death.

**EXAMPLE** A single individual who is not involved in an unincorporated business dies on March 1, 2020 without having filed a 2019 return.

**ANALYSIS** The due date for the 2019 return is September 1, 2020, six months after the individual's death. The due date for the 2020 final return is April 30, 2021.

2-20. The provision works somewhat differently for an individual who has a June 15 filing due date due to business income. If such an individual dies between November 1 and December 15 of a taxation year, the later of six months after the date of death and the normal filing due date, will be the normal filing date of June 15. This means that for decedents who would normally have a June 15 filing due date, the six month extension is available if they die between December 16 of a taxation year and June 15 of the following year.

**EXAMPLE** An individual whose wife owns an unincorporated business dies on May 2, 2020 without having filed a 2019 tax return.

**ANALYSIS** The due date for the 2019 return is November 2, 2020, six months after the individual's death. The due date for the 2020 final return is June 15, 2021.

## Exercise Two - 2

**Subject:** Deceased Taxpayer Filing Date

Sally Cheung dies on February 15, 2020. Sally's only income for 2019 and 2020 was from investments. Her husband's Net Income for these years included income from an unincorporated business. Her representatives must file her 2019 and 2020 tax returns by what dates? Explain your answer.

**SOLUTION available in print and online Study Guide.**

# Withholdings For Income Tax - ITA 153

## *Salaries And Wages*

2-21. A large portion of the income taxes paid by individuals employed in Canada is collected through source deductions. Under ITA 153, any individual who earns employment income will have the estimated taxes on this income withheld from gross pay through payroll deductions made by their employer. The tax withheld is related to the amount of the individual's income, with the required withholdings intended to cover the tax payable on this income. However, it would be unusual for such withholding to be exactly equal to the taxes payable for the year. As a consequence, most individuals will either owe taxes and be required to file a tax return or, alternatively, be entitled to a refund that can only be obtained by filing a tax return.

2-22. The amount withheld by an employer is based on a form that is filled out by each employee, Form TD1, "Personal Tax Credits Return". This form lists personal and other credits that are available to an individual and asks the employee to indicate which of these he will be claiming.

2-23. Also on Form TD1, an individual can request to have the amount withheld increased beyond the required amount. An individual might choose to do this if his employment income withholding is based on rates in a low tax rate province, but his residence is in a high tax rate province (e.g., an individual who works in Alberta, but lives in Saskatchewan). Another situation where this might be desirable would be if an individual received large taxable spousal support payments as these are not subject to withholding. In either of these cases, requesting additional withholding would allow the individual to pay extra taxes each pay period and avoid a large tax liability on filing, or the requirement to pay instalments.

2-24. A different type of problem can arise when an employed individual has significant deductions from income, losses, or non-refundable tax credits not listed on the TD1, that can

be used to offset the taxes on employment income.

> **EXAMPLE** Monica Kinney has annual employment income that places her in the middle of the 29 percent tax bracket. Her employer would base her withholdings on her estimated employment income for the year. However, if Monica makes annual deductible spousal support payments of $20,000, her Taxable Income will be reduced by this amount, resulting in a reduction in federal Tax Payable of $5,800 [($20,000)(29%)]. If provincial income taxes are taken into consideration, a further reduction in income taxes payable would be available.

2-25. In this situation, Monica can request a reduction in the amount of tax withheld by her employer by using Form T1213, "Request To Reduce Tax Deductions At Source". As long as the deductions (e.g., payroll deductions for an RRSP), losses (e.g., rental loss) or tax credits (e.g. for charitable donations) can be documented in a reasonable fashion, the CRA will normally authorize the employer to reduce the tax withheld from the employee's remuneration.

### *Withholdings By Other Payers*

2-26. In addition to requiring employers to withhold specified amounts from the salaries and wages of employees, ITA 153 contains a fairly long list of other types of payments from which the payer must withhold prescribed amounts. These include:

- retiring allowances
- death benefits
- payments from Registered Retirement Savings Plans
- payments from Registered Education Savings Plans
- distributions under retirement compensation arrangements

2-27. In addition to payments listed in ITA 153, withholding is required on certain payments to non-residents. While the general rate of tax on the Canadian source income of non-residents is established in ITA 212 as 25 percent, the amount that will actually be withheld is usually modified by international tax treaties. For a more complete discussion of this type of withholding, see Chapter 20, International Issues In Taxation.

## Instalment Payments For Individuals - ITA 156

### *Basis For Requiring Instalments*

2-28. As discussed in the previous section, amounts to be applied to future tax liabilities must be withheld by the payer from certain types of income. Such income includes employment income, as well as other less common sources.

2-29. For many individuals, particularly those earning employment income, the withholding of taxes constitutes the major form of tax payment in any taxation year. However, in situations where an individual has large amounts of income that are not subject to withholding (e.g., self-employment income or investment income), quarterly instalment payments may have to be made towards the current year's tax liability.

2-30. In the *Income Tax Act*, the requirement for paying instalments is stated in terms of when instalments are not required. Specifically, no instalments are required if:

> **ITA 156.1(2)(b)** The individual's net tax owing for the particular year, or for each of the 2 preceding taxation years, does not exceed the individual's instalment threshold for that year.

2-31. In provinces other than Quebec, "net tax owing" is the amount, if any, by which the total federal and provincial tax owing for a particular year, exceeds all tax withheld for that year. An "individual's instalment threshold" is defined in ITA 156.1(1) as $3,000. In Quebec, net tax owing only includes federal taxes and the instalment threshold is $1,800.

2-32. While the legislation is based on when instalments are not required, it is usually more useful to give guidance in terms of when instalments are required. The requirement could be restated as follows:

You are required to make instalment payments for 2019 if your **net tax owing** is more than $3,000:

- in 2019; **and**
- in **either** 2018 **or** 2017.

Note that **net tax owing** is not equal to **Tax Payable** if any income tax has been withheld.

### Due Dates For Individuals

2-33. For individuals required to pay instalments, the quarterly payments are due on March 15, June 15, September 15, and December 15.

### Determining Amounts Of Instalments

2-34. In simple terms, the required instalments will be based on the net tax owing for the current year, the preceding year, or a combination of the first and second preceding years. The *Canada Pension Plan Act* and the *Employment Insurance Act* provide for instalments on the same basis as that of the *Income Tax Act*. Since the CRA administers the Canada Pension Plan (CPP) and Employment Insurance (EI), where an individual has CPP contributions and/or EI premiums payable on self-employed income (see Chapter 3), the instalments are based on the total of net tax owing plus any CPP contributions and EI premiums payable.

2-35. In determining the amount to be paid as instalments, individuals have a choice of three alternatives for calculating the required quarterly instalments as follows:

**Alternative 1 - Current Year** One-quarter of the estimated net tax owing (not Tax Payable) for the current taxation year [ITA 156(1)(a)(i)].

**Alternative 2 - Preceding Year** One-quarter of the net tax owing for the immediately preceding taxation year [ITA 156(1)(a)(ii)].

**Alternative 3 - Second And First Preceding Year** The first two instalments (March 15 and June 15) based on one-quarter of the net tax owing for the second preceding taxation year. The remaining two instalments (September 15 and December 15) equal the excess of the net tax owing for the preceding year over one-half of the net tax owing for the second preceding year [ITA 156(1)(b)], divided by two. Note that one-half of the net tax owing for the second preceding year is the amount that should have been paid in the first two instalments under this approach.

In effect, in almost all situations, Alternative 3 requires the same total instalments as Alternative 2. However, if the net tax owing in the second preceding year is less than the net tax owing in the preceding year, there is some amount of tax deferral.

2-36. The individual taxpayer can select the most advantageous of these alternatives. The basic rules for this selection are as follows:

- If the net tax owing is lowest in the current year, Alternative 1 is best.
- If the net tax owing is lowest in the preceding year, Alternative 2 is best.
- If the net tax owing is lowest in the second preceding year:
  - and the net tax owing in the first preceding year is higher than the current year, Alternative 1 is best.
  - and the net tax owing in the first preceding year is lower than the current year, Alternative 3 is best. While the total amount of the instalments will be the same as in Alternative 2, their present value will be less because of the reduced amount for the first two payments.

### CRA's Instalment Reminders

2-37. The CRA wants to ensure that individuals who are required to pay instalments have received an Instalment Reminder. If an individual is registered for the MyAccount service (see Paragraph 2-91), the CRA emails a notification that there is new online mail, otherwise the Instalment Reminders are sent by mail. Taxpayers are assured that, if they pay the amounts

specified in these reminders by the due dates, no interest will be assessed for late instalments.

2-38. The amounts specified in these Instalment Reminders are based on Alternative 3. The reason that the CRA has adopted this approach is based on information availability:

**Alternative 1** The CRA would not know the current year's Tax Payable until April 30 or June 15 of the following year. This would be too late for advising a taxpayer as to any of the current year's instalments under this approach.

**Alternative 2** The CRA would not know the previous year's Tax Payable until April 30 or June 15 of the current year. This would too late for advising a taxpayer as to the first required instalment for the current year and, in the case of June 15 filers, too late to provide information on the second required instalment for the current year.

2-39. Given this situation, Alternative 3 is the only approach that could be used by the CRA to provide taxpayers with instalment information that would unequivocally avoid any assessment of interest.

2-40. While using the amounts specified in the Instalment Reminder is a risk free solution to remitting instalments, it may not be the best answer for an individual taxpayer.

**EXAMPLE** Ali Kern, a self-employed general contractor, had Taxable Income in both 2017 and 2018 that was in excess of $200,000. Unfortunately, in early 2019 he was in a serious accident and could not work all year. His business experienced significant losses which ultimately resulted in a Taxable Income of nil.

**ANALYSIS** The CRA's Instalment Reminders would base its calculations on the high levels of income for 2017 and 2018. Paying these amounts would be a very poor choice as it would, in essence, constitute an interest free loan to the government. As Ali knew early in the year that he would have little or no income, his best choice would be to make no instalments based on his estimated current year net tax owing of nil.

2-41. However, if an individual does not pay the amounts calculated in the CRA's Instalment Reminders, the taxpayer is basing some or all of his payments on estimates. If his estimates are too low, he will be assessed interest on any insufficient instalments.

### Example Of Instalments For Individuals

2-42. A simple example will serve to illustrate the alternative approaches to calculating instalments.

**EXAMPLE** Mr. Hruba is not subject to any withholding and has the following amounts of net tax owing:

| | |
|---|---|
| 2017 | $20,000 |
| 2018 | 32,000 |
| 2019 (Estimated) | 24,000 |

**ANALYSIS** The use of alternative 1 based on the 2019 estimate of $24,000 would result in quarterly instalments of $6,000 ($24,000 ÷ 4), totaling $24,000 for the year.

Alternative 2, based on the 2018 figure of $32,000 is the worst alternative. The quarterly instalments would be $8,000 ($32,000 ÷ 4), totaling $32,000 for the year.

Under alternative 3 (used in the CRA's Instalment Reminders), instalments 1 and 2 would each be $5,000 ($20,000 ÷ 4). However, instalments 3 and 4 would each be $11,000 [($32,000 - $10,000) ÷ 2], resulting in a total of $32,000.

This analysis would suggest that alternative 1 provides the best solution. While the first two payments under alternative 3 are somewhat lower ($5,000 vs. $6,000), the total amount under alternative 1 is significantly lower ($24,000 vs. $32,000).

2-43. The CRA will calculate interest based on each instalment that should have been paid using the payment option that requires the least amount of interest to a specific date. The CRA will then calculate interest based on the instalments that were paid. If the former amount

exceeds the latter, the individual will be assessed interest on the difference, provided the amount involved exceeds $25. Note that contra interest as explained in Paragraph 2-46 could also be relevant in calculating the applicable interest.

## Exercise Two - 3

**Subject:** Individual Instalments

Marlene Carter, a resident of Ontario, had net tax owing for 2017 of $3,500, net tax owing for 2018 of $4,000, and expects to have net tax owing for 2019 of $1,500. Is she required to make instalment payments for 2019? If so, what would be the minimum quarterly payment and when would they be due?

## Exercise Two - 4

**Subject:** Individual Instalments

John Lee, a resident of Newfoundland, had net tax owing for 2017 of $3,500, net tax owing for 2018 of $1,500, and expects to have net tax owing for 2019 of $4,500. Is he required to make instalment payments for 2019? If so, what would be the minimum quarterly payment and when would they be due?

## Exercise Two - 5

**Subject:** Individual Instalments

At the beginning of 2019, the following information relates to Jesse Forbes:

| Year | Tax Payable | Amounts Withheld |
|---|---|---|
| 2017 | $53,000 | $52,000 |
| 2018 | 59,000 | 52,000 |
| 2019 (Estimated) | 64,000 | 60,000 |

Is Jesse required to make instalment payments during 2019? If he is required to make instalment payments, indicate the amounts that would be required under each of the three alternative methods of calculating instalments. Indicate which alternative would be preferable.

**SOLUTIONS available in print and online Study Guide.**

**We suggest you work Self Study Problem Two-1 at this point.**

# Interest

## *When Interest Is Charged*

2-44. Interest is assessed on any amounts that are not paid when they are due. For individuals, this would include:

- Any balance owing on April 30th of the current year for the taxes of the preceding year. We would remind you that the amount owing is due on April 30th, without regard to whether the taxpayer's filing due date is April 30 or June 15.
- Any portion of a required instalment payment that is not remitted on the required instalment due date.
- On some penalties. For example, interest is charged on penalties for late filing (see following discussion of this penalty).

2-45. Compound daily interest is charged on these amounts. In the case of amounts owing on April 30th, the start date for interest is May 1, with the accrual continuing until the amounts are paid. For deficient instalment amounts, the interest clock starts ticking on the date the instalment is due. This accrual would continue until an offset occurs (see next paragraph) or the due date for the balance owing. At this latter date, further interest would be based on the amount owing at that date.

2-46. A further important point here is that interest accrued on late or deficient instalments can be offset by making instalment payments prior to their due date, or by paying an amount in excess of the amount required (creating contra interest). Note, however, if early or excess payments are made when there is no accrual of interest owed on late or deficient instalments, the government will not pay interest to the taxpayer on the excess.

### *Prescribed Rates Of Interest*

2-47. There are a number of provisions in the *Income Tax Act* which require the use of an assumed rate of interest. What we refer to as the prescribed base rate is an annual rate that is calculated each quarter, based on the effective yield on three month Government of Canada treasury bills during the first month of the preceding quarter. The CRA announces this prescribed base rate for each quarter a few weeks before the start of the quarter.

2-48. Many years ago there was a single prescribed rate. However, the government felt that this rate was sufficiently low that too many taxpayers chose not to make required tax payments. To try to solve this problem, on amounts owing to the government, 4 percentage points were added to the prescribed base rate as described in the preceding paragraph. At the same time, a third rate was established for amounts owed to taxpayers.

2-49. As a result, there are now multiple prescribed interest rates and ITR 4301 contains the calculations for these rates. The rates that concern us here are:

> **Base Rate** This rate, described in Paragraph 2-47, is applicable for all purposes except amounts owing to and from the CRA (e.g., the determination of the taxable benefit for an employee who receives an interest free loan from an employer). For the first and second quarters of 2019, this rate was 2 percent.
>
> **Base Rate Plus 2 Percent** This rate is applicable when calculating interest on refunds to individuals and trusts, but not corporations. For the first and second quarters of 2019, this rate was 4 percent.
>
> Interest rates on short term investments are much lower than the prescribed rate plus 2 percent. To prevent corporations from overpaying instalments to take advantage of the higher interest rates paid by the CRA, the rate on amounts owed to corporations is only the base rate and does not include the extra 2 percent.
>
> **Base Rate Plus 4 Percent** This rate is applicable when calculating interest on late or deficient instalments, unpaid source deductions, and other amounts owing to the CRA by all taxpayers. For the first and second quarters of 2019, this rate was 6 percent. Note that amounts paid to the CRA under this provision are not deductible for any taxpayer.

2-50. Many individuals are faced with the choice of either making their instalment payments or, alternatively, paying off other types of liabilities that they have accumulated. In many cases, the interest rate on other debts is higher than 6 percent.

> **EXAMPLE** Jasmine Ho has determined that her March instalment for 2019 will be $7,500. She owes $7,500 on her Visa credit card for personal expenditures. Jasmine does not have the funds to pay both the credit card debt and her tax instalment.
>
> **ANALYSIS** The annual interest rate that will be charged on her Visa balance is likely to be around 20 percent. This compares to a current rate on late tax instalments of 6 percent. Without regard to financial planning issues, Jasmine would clearly reduce her interest costs by paying off the credit card debt, as opposed to making her instalment payment.

# Penalties

## Late Filing Penalty

2-51. If the deadline for filing an income tax return is not met, the CRA assesses a penalty. For a first offence, this penalty amounts to 5 percent of the tax that was unpaid at the filing due date, plus 1 percent for each complete month (part months do not count) the unpaid tax is outstanding up to a maximum of 12 months. This penalty would be in addition to interest on the amounts due. If there are no taxes owed on the due date, or if the taxpayer is entitled to a refund, the late filing penalty would be nil.

2-52. If the taxpayer has been charged a late filing penalty in any of the three preceding taxation years, the CRA can double the penalty on the second offence to 10 percent of the tax owing, plus 2 percent per month up to a maximum of 20 months. This will happen if the second late filed return is filed after the CRA has already sent a demand to file that return.

2-53. In terms of tax planning, the penalty for late filing is sufficiently severe that individuals should make every effort to file their income tax returns no later than the deadline (April 30 or June 15), even if all of the taxes owing cannot be paid at that time. This is of particular importance if they have filed late in one of the three preceding years.

2-54. This point is sometimes forgotten when the previous offence resulted in a negligible penalty. The penalty for a second offence will double, even if the amount involved in the first penalty was very small.

## Late Or Deficient Instalments Penalty

2-55. There is no penalty for late payment of income taxes or on moderate amounts of late or deficient instalments. However, there is a penalty when large amounts of late or deficient instalments are involved. This penalty is specified in ITA 163.1 and is equal to 50 percent of the amount by which the interest owing on the late or deficient instalments exceeds the greater of $1,000 and 25 percent of the interest that would be owing if no instalments were made. As this penalty does not kick in unless the amount of interest exceeds $1,000, it would only apply to fairly large amounts of late or deficient instalments.

### Exercise Two - 6

**Subject**: Penalties And Interest For Individuals

Despite the fact that her net tax owing has been between $3,000 and $4,000 in the two previous years, and is expected to be a similar amount during 2019, Mary Carlos has made no instalment payments for 2019. While her normal filing date would be April 30, 2020, she does not file her 2019 return or pay the balance owing until July 20, 2020. What penalties and interest will be assessed for the 2019 taxation year?

**SOLUTION available in print and online Study Guide.**

# Due Date For Balance Owing - Living Individuals

2-56. If the combination of amounts withheld and instalments paid falls short of the total taxes payable for the taxation year, there will be a balance owing. For living individuals, ITA 248(1) defines the "balance due date" as April 30, without regard to whether the taxpayer qualifies for the June 15 filing due date because of business income.

# Deceased Taxpayers - Balance Due Dates And Final Returns

## Balance Due Dates - Deceased Taxpayer

2-57. The due date for the amount owing for the year of death is generally April 30th of the year following death. However, if the taxpayer is eligible for the six month extension of the filing due date for the current or previous year's return, the balance due date for that return is

also extended to the revised filing due date.

> **EXAMPLE** Before filing her 2019 tax return, Joanne Rivers dies on March 31, 2020. For 2019 and 2020, her income was from her business. No instalments were required. There is a balance owing for both years. What are the due dates for these amounts?
>
> **ANALYSIS** Her 2019 return will be due on September 30, 2020, six months after her death. Any balance owing for 2019 will be due at that time. Although her final return for 2020 will be due on June 15, 2021, any balance owing for 2020 will be due on April 30, 2021.

### *Final Returns - Special Rules Applicable At Death*

2-58. Dealing with the death of a taxpayer is a very complex area of tax practice. In fact, for an individual with a substantial estate and/or a number of beneficiaries, it usually requires the services of a tax practitioner who specializes in the area. Complete coverage of this subject goes well beyond the scope of this general text.

2-59. However, we will provide some coverage of a few of the more important issues that arise when an individual dies. For example, in Chapter 9 we discuss the deemed disposition of capital assets at death and in Chapter 11 we cover the special rules that apply to net capital losses in the year of death.

2-60. Additional filing issues related to the deceased taxpayers, such as returns to be filed and available credits, are covered in an Appendix to Chapter 11.

# Returns And Payments - Corporations

## Due Date For Corporate Returns - ITA 150

2-61. Unlike the case with individuals, the taxation year of a corporation can end on any day of the calendar year. This makes it impossible to have a uniform filing date and, as a consequence, the filing deadline for corporations is specified as six months after the fiscal year end of the company.

2-62. Under ITA 150(1)(a), corporations (other than corporations that are registered charities) that are resident in Canada at any time in the year, carry on business in Canada, have a taxable capital gain, dispose of Taxable Canadian Property, or would be subject to Canadian tax if not for an international tax treaty, are required to file a corporate tax return, Form T2, within this specified period. Information from the financial statements must accompany this form, along with other required schedules.

## Filing Alternatives For Corporations

### *Paper Vs. Electronic Filing*

2-63. ITA 150.1(2.1) indicates that prescribed corporations must file their returns electronically. They do not have the option to paper file. For this purpose, prescribed corporations are those that have gross revenues in excess of $1 million. Corporations with gross revenues of $1 million or less can choose to paper file or to file their return electronically.

### *Use Of Functional Currency*

2-64. If a Canadian enterprise has foreign operations, it is likely that some of their records will be maintained in a foreign currency. If these records are translated into Canadian dollars in order to file the required return, there may be a problem. The use of some translation procedures can introduce what many analysts believe are distortions in the reported results.

2-65. To correct this situation, ITA 261 allows the determination of Canadian tax liabilities on the basis of financial statements prepared in the corporation's functional currency. For this purpose, functional currency is defined as follows:

"**functional currency**" of a taxpayer for a taxation year means the currency of a country other than Canada if that currency is, throughout the taxation year,

(a) a qualifying currency; and
(b) the primary currency in which the taxpayer maintains its records and books of account for financial reporting purposes.

2-66. ITA 261 provides the following definition of qualifying currency:

"**qualifying currency**" at any time means each of
(a) the currency of the United States of America;
(b) the currency of the European Monetary Union;
(c) the currency of the United Kingdom;
(d) the currency of Australia; and
(e) a prescribed currency.

2-67. You should also note that the term "functional currency" has a different meaning in the *Income Tax Act* than it does in Canadian and International Financial Reporting Standards. Financial reporting standards use this term to refer to the currency of the primary economic environment in which the corporation operates, without regard to the currency in which the corporation keeps its records.

## Instalment Payments For Corporations

### *Instalment Threshold*

2-68. Corporations are generally required to make monthly instalment payments throughout their taxation year. However, this requirement is eliminated if either the estimated Tax Payable for the current year or the Tax Payable for the preceding taxation year does not exceed $3,000 (combined federal and provincial). In addition, special rules apply to some "Canadian Controlled Private Corporations", or CCPCs. While CCPCs will be defined more precisely in Chapter 12, at this point we would note that a CCPC is a private corporation that is controlled by residents of Canada and does not have any of its shares traded in public markets. The special instalment rules applicable to these CCPCs will be discussed beginning at Paragraph 2-71.

### *Calculating The Amount - General Rules (Excluding Small CCPCs)*

2-69. When instalments are required, they must be paid on or before the last day of each month, with the amount being calculated on the basis of one of three alternatives. As laid out in ITA 157(1)(a), these alternatives are as follows:

1. **Current Year** - 12 instalments, each based on 1/12 of the estimated tax payable for the current year.

2. **Preceding Year** - 12 instalments, each based on 1/12 of the tax that was payable in the immediately preceding year.

3. **Second And First Preceding Year** - 2 instalments, each based on 1/12 of the tax that was payable in the second preceding year, followed by 10 instalments based on 1/10 of the amount by which the taxes paid in the immediately preceding year exceeds the sum of the first two instalments.

2-70. Choosing between these alternatives is usually a relatively simple matter. The choice should be the instalment base that provides the minimum total cash outflow or, in those cases where alternative bases result in the same total cash outflow, the alternative that provides the greatest amount of deferral. For businesses that are experiencing year to year increases in their taxes payable, the third alternative will generally meet this objective. Note, however, the total cash outflow under the third alternative will usually be the same as the total cash outflow under the second alternative.

**EXAMPLE** The Marshall Company, a public company, estimates that its 2019 taxes payable will be $153,000. In 2018, the Company paid taxes of $126,000. The corresponding figure for 2017 was $96,000.

**ANALYSIS** The choices for instalment payments for Marshall Company would be:

1. 12 instalments of $12,750 each ($153,000 ÷ 12) totaling $153,000.
2. 12 instalments of $10,500 each ($126,000 ÷ 12) totaling $126,000.
3. 2 instalments of $8,000 each ($96,000 ÷ 12) and 10 instalments of $11,000 each [($126,000 - $16,000) ÷ 10] totaling $126,000.

While the cash outflows under alternative 3 total the same amount as those under alternative 2, alternative 3 would be selected because the first two payments are smaller and provide a deferral to the last 10 payments.

### Calculating The Amount - Small CCPCs

2-71. "Small" CCPCs are allowed to pay instalments on a quarterly basis. ITA 157(1.2) defines a small CCPC as one for which:

- the Taxable Income of the corporation and its associated corporations does not exceed $500,000 during the current or the previous taxation year;
- the Taxable Capital Employed In Canada of the corporation and its associated corporations does not exceed $10 million for the current or previous year;
- an amount has been deducted under ITA 125 (the small business deduction) for the current or previous year; and
- a perfect compliance record has been maintained with respect to payments and filings (for GST, source deductions and income taxes) during the last 12 months.

2-72. For CCPCs that meet this definition, ITA 157(1.1) provides three alternatives for calculating instalments:

1. **Current Year** - 4 instalments, each based on 1/4 of the estimated tax payable for the current taxation year.
2. **Preceding Year** - 4 instalments, each based on 1/4 of the tax that was payable in the immediately preceding taxation year.
3. **Second And First Preceding Year** - 1 instalment based on 1/4 of the tax that was payable in the second preceding taxation year, followed by 3 instalments based on 1/3 of the amount by which the taxes paid in the immediately preceding taxation year exceeds the first instalment.

2-73. The payments are required on or before the last day of each of the fiscal quarters.

## Exercise Two - 7

**Subject:** Corporate Instalments

Madco Ltd. is not a small CCPC. It has a December 31 year end. For 2017, its tax payable was $32,000, while for 2018, the amount was $59,000. For 2019, its estimated tax payable is $74,000. What would be the minimum instalments for 2019 and when would they be due? How would your answer differ if Madco Ltd. was a small CCPC?

**SOLUTION available in print and online Study Guide.**

## Exercise Two - 8

**Subject:** Corporate Instalments

Fadco Inc. is not a small CCPC. It has a November 30 year end. For the taxation year ending November 30, 2017, its tax payable was $102,000, while for the 2018 taxation year, the amount was $54,000. For the 2019 taxation year, its estimated tax payable is $17,000. What would be the minimum instalments for 2019 and when would they be due? How would your answer differ if Fadco Inc. was a small CCPC?

**SOLUTIONS available in print and online Study Guide.**

## Due Date For Balance Owing - Corporations

2-74. Regardless of the instalment base selected, any remaining taxes are due within two months of the corporation's fiscal year end. An exception is made in the case of Canadian controlled private corporations (CCPCs) that have claimed the small business deduction in the current or preceding taxation year. For these corporations, the due date is three months after their fiscal year end, provided their Taxable Income did not exceed $500,000 for the previous year. To qualify for this deferred due date, the corporation only has to be a CCPC. It does not have to be a "small" CCPC as described in Paragraph 2-71.

2-75. Note that the final due date for payment is earlier than the due date for filing returns. For example, a company with a March 31 year end that is not eligible for the small business deduction would not have to file its tax return until September 30. However, all of its taxes would be due on May 31. This means that this final payment will often have to be based on an estimate of the total amount of taxes payable.

## Exercise Two - 9

**Subject:** Corporate Due Date

The taxation year end for Radco Inc. is January 31, 2019. Indicate the date on which the corporate tax return must be filed, as well as the date on which any final payment of taxes is due.

**SOLUTION available in print and online Study Guide.**

## Interest And Penalties For Corporations

2-76. The basic rules for interest on corporate balances owing or receivable are generally the same as those applicable to individuals. These were covered beginning in Paragraph 2-44. However, as described in Paragraph 2-48, interest paid to corporations on overpayments is calculated at the regular rate, not at the higher rate applicable to individuals and trusts.

2-77. Note that it is especially important that corporations avoid interest on late tax or instalment payments. Since corporations can usually deduct any interest expense that they incur, the payment of non-deductible interest on late tax payments represents a high cost source of financing. For example, if a corporation is paying taxes at a rate of 25 percent, interest at a non-deductible rate of 5 percent is the equivalent of a deductible interest rate of 6.7 percent [5% ÷ (1 - .25)]. Many corporations, particularly those that are publicly traded, are able to access financing at rates that are lower than this.

2-78. The previously covered penalties applicable to individuals for late filing of returns and for large amounts of late instalments (see Paragraphs 2-51 and 2-55) are equally applicable to corporations. In addition to the penalties applicable to individuals, ITA 235 contains a further penalty applicable to large corporations. It calls for a penalty equal to .0005 percent

per month of a corporation's Taxable Capital Employed In Canada. This will be assessed for a maximum period of 40 months.

2-79. This is a fairly harsh penalty in that, unlike the usual penalties that are based on any additional tax payable at the time the return should have been filed, this penalty is based on the capital of the enterprise, without regard to earnings or tax payable for the year. For example, CNR has December 31, 2017 Shareholders' Equity (roughly the equivalent of Taxable Capital Employed In Canada) of $16,656 billion. If the .0005 percent penalty was applied to this balance for 40 months, the total penalty would be $3,331,200.

**We suggest you work Self Study Problems Two-2, 3, and 4 at this point.**

# Returns And Payments - Trusts

## Types Of Trusts

2-80. As defined in the Glossary to this text, a testamentary trust is a trust that arises on, and as a consequence of, the death of an individual. All other trusts are referred to as inter vivos trusts.

## Filing Requirements

2-81. In general, a trust must file a trust income tax return (a.k.a., T3), if it:

- has Tax Payable for the year;
- is requested by the CRA to file a tax return;
- has disposed of a capital property during the year; or
- has a taxable capital gain during the year.

2-82. There are other reasons for filing listed in the T3 Trust Guide. However, none are of sufficient importance to deal with here.

## Due Dates For Returns

2-83. In general, all inter vivos and testamentary trusts, other than graduated rate estates, must use the calendar year as their taxation year. A testamentary trust designated as a graduated rate estate can use a non-calendar fiscal period for the duration of its limited life. All trusts must file their tax returns within 90 days of the end of their taxation year.

## Payment Of Taxes

2-84. Legislation generally requires that all trusts, except graduated rate estates, make instalment payments. However, it does not appear that the CRA intends to enforce this requirement.

2-85. With respect to determining the amount of the instalments, the rules in ITA 156(1) cover both individuals and trusts. This means that, as was discussed in Paragraph 2-35 for individuals, trusts have three alternatives for calculating instalment amounts and the due dates are March 15, June 15, September 15 and December 15.

2-86. Any balance owing when the return is filed must be remitted with the return. Stated alternatively, the balance is due 90 days after the end of the trust's taxation year, generally March 31.

## Interest And Penalties

2-87. For both testamentary and inter vivos trusts, interest on late final balance payments is calculated using the same rules as those applicable to individuals. In addition, late filing penalties for trusts are the same as those for individuals. However, it is the administrative practice of the CRA not to assess interest or penalties on late instalments.

**We suggest you work Self Study Problem Two-5 at this point.**

# Income Tax Information Returns

2-88. ITA 221(1)(d) gives the CRA the right to require certain taxpayers to file information returns in addition to the returns in which they report their taxable income. These information returns are described in Part II of the Income Tax Regulations and must be filed using a prescribed form. Common examples of these returns and the related prescribed form would be as follows:

- **T3** This form is used by trustees (which includes trustees of some mutual funds) and executors to report the allocation of the trust's income.
- **T4** This form is used by employers to report remuneration and taxable benefits paid to employees and the various amounts withheld for source deductions.
- **T5** This form is used by organizations to report interest, dividend, and royalty payments.
- **T4RSP** This form is used by trustees to report payments out of Registered Retirement Savings Plans.

# Books And Records

2-89. As indicated in IC78-10R5, "Books And Records Retention/Destruction":

> Books and records have to be kept for the period or periods provided by subsections 230(4) to (7) and section 5800 of the *Income Tax Regulations* ...

2-90. While for many of these documents, the specified retention period is 6 years, there are many variations in the length of the retention period, with both longer and shorter periods being specified in the sources cited in Paragraph 2-89.

# Assessments And The CRA My Account Service

## CRA Website - My Account Service

2-91. The CRA invests considerable resources on continual improvements to its website and electronic services. The goal is to reduce costs and provide faster, more efficient services to taxpayers. For example, the Auto-Fill My Return service allows individuals and authorized representatives to automatically fill in parts of a current year income tax return. The CRA website contains the My Account service which is a secure online portal that allows registered individuals to see many of their tax accounts online and manage their tax information. There is a similar My Business Account service available for businesses. The CRA website contains a list of its ever expanding electronic services. For the My Account service, the available information includes access to Notices of Assessment, RRSP and TFSA contribution limits, instalments paid and payable and many other past and present balances.

## Notice Of Assessment

2-92. After a tax return has been filed, the CRA runs a number of tests on the return, such as verifying the eligibility for various deductions (e.g., RRSP deductions) and tax credits (e.g., age credit). After processing a return, the CRA completes a Notice of Assessment which contains the amount, if any, of taxes to be paid or refunded, an explanation of any changes it has made to the return, and any interest and penalties that were assessed. For individuals, it also contains additional information such as the taxpayer's RRSP deduction limit. For individuals, the Notice of Assessment is available online in the My Account service, often within a few weeks of filing. A somewhat longer period is normally required for corporate income tax assessments and more complicated individual returns. The CRA will mail out the Notice of Assessment unless the taxpayer has opted instead to have e-mail notification as soon as it is available to be viewed online.

## Notice Of Reassessment

2-93. The Notice of Assessment does not free the taxpayer from additional scrutiny of the return. The CRA is under pressure to issue Notice of Assessments quickly so the initial

assessment is not based on an in-depth review of the return. A more detailed review of many returns is done after the Notice of Assessment has been completed. The CRA has a matching program that compares information the CRA has received from third parties, such as employers and financial institutions with the relevant returns. The CRA will issue a Notice of Reassessment with a revised amount payable or refunded and an explanation if a change is made to a taxpayer's return for any reason such as amounts not matching or duplicate claims on a spouse's return. Like the Notice of Assessment, the Notice of Reassessment can be viewed online if the taxpayer has registered for the My Account service.

2-94. The normal reassessment period is the period that ends 3 years after the date on the Notice of Assessment for individuals, most trusts, and Canadian controlled private corporations. This normal reassessment period is extended to 4 years for other corporations because of the greater complexity that may be involved in the review process. There are a number of exceptions to this normal 3 year reassessment period that include the following:

- Reassessment can occur at any time:
  - if the taxpayer or person filing the return has made any misrepresentation that is attributable to neglect, carelessness or willful default, or has committed any fraud in filing the return or in supplying information,
  - if the taxpayer has filed a waiver of the 3 year time limit.
- Reassessment can occur outside the normal reassessment period:
  - if an individual or testamentary trust has requested a reduction in taxes, interest, or penalties. The ability to use this provision is limited to 10 years after the particular year in question,
  - when reassessment within the normal period affects a balance outside of this period,
  - in situations where the taxpayer is claiming certain specified deductions. An example of this would be a listed personal property loss being carried back to claim a refund of taxes paid.

# Refunds

2-95. When tax has been withheld from income and/or instalments have been paid, the CRA's Notice of Assessment may show that there has been an overpayment of income tax. In this situation, the taxpayer is entitled to a refund of any excess payments and, in the great majority of cases, such refunds are sent without any further action being taken. If, for some reason, the refund is not made, the taxpayer can apply for it in writing within the normal reassessment period. However, if there are other tax liabilities outstanding, such as amounts owing from prior years, the CRA has the right to apply the refund against these liabilities.

2-96. A further point here is that refunds will not generally be made if the return is filed more than 3 years after the end of that year (e.g., a refund on a 2015 tax return that is filed in 2019 will not be paid in the normal course of events).

2-97. Interest is paid on overpayments of income tax at the prescribed rate (see Paragraph 2-49). For individuals, interest at the prescribed base rate, plus 2 percentage points, begins to accrue on the later of two dates:

- 30 days after the balance due date (generally, April 30); or
- 30 days after the return is filed.

2-98. For an individual with business or professional income, the normal filing date would be June 15. If such an individual was entitled to a refund and waited until this date to file, interest would not begin to accrue until 30 days after June 15.

2-99. For corporations, interest on refunds at the prescribed base rate, without the additional 2 percentage points, begins to accrue at the later of two dates. These are:

- 120 days after the corporate year end; or
- 30 days after the corporation's tax return is filed (unless it is not filed prior to the due date, in which case the due date is applicable).

2-100. Taxpayers can request that any refund due to them be transferred to their tax instalment account. The advantage of this is that the transfer would normally occur more quickly than the issuance of a refund. This option is available on the corporate tax return, but is only available through a separate written request in the case of personal tax returns. This is one reason it is not commonly used by individuals.

# Adjustments To Income Tax Returns

2-101. There is no general provision in the *Income Tax Act* for filing an amended return. However, this does not mean that amounts included in the returns of previous years cannot be altered. It simply means that the adjustment process normally takes place after the return has been processed and a Notice of Assessment has been received.

2-102. There are many reasons why adjustments to a previously filed return could be necessary. Besides the obvious omissions or errors (i.e., omitting a charitable donation receipt or making an error in recording the information on a T4), there are many other possible reasons. Information received after the return was filed, for example, learning through a tax course that a parent should have been claimed as a dependant, would make an adjustment of a prior return advantageous.

2-103. IC 75-7R3, "Reassessment of a Return of Income", permits such adjustments if the following conditions are met:

- the CRA is satisfied that the previous assessment was incorrect;
- the reassessment can be made within the normal reassessment period or the taxpayer has filed a waiver;
- the requested decrease in taxable income does not solely depend on an increase in a permissive deduction such as capital cost allowance;
- the change is not based solely on a successful appeal to the courts by another taxpayer; and
- the taxpayer's return has been filed within 3 years of the end of the year to which it relates.

2-104. For individuals, changes can be requested through the CRA website by using the My Account service, or by mailing Form T1-ADJ, "T1 Adjustment Request" or a letter detailing the adjustment requested. The calculations required to issue a reassessment are taken care of by the CRA. This informal procedure can be used any time within the normal reassessment period, provided the return has been filed within 3 years of the end of the year to which it relates.

# Disputes And Appeals

## Representation By Others

2-105. At the initial stages of any dispute, a taxpayer may wish to represent himself. However, if complex issues are involved, or if the dispute progresses to a later stage where procedures require more formal representation, a taxpayer is likely to authorize some other party to act as their representative.

2-106. The CRA's "Represent A Client" service is designed to provide online access to both individual and business tax information by authorized representatives registered with the CRA. The registration process is relatively simple as this service is not designed solely for tax professionals, but can also be used by friends and family members of the taxpayer.

2-107. There are many services available through "Represent A Client". The list is available on the CRA website and includes most of the services available through My Account.

2-108. In order for the CRA to discuss any matter, including the issue in dispute, with anyone other than the taxpayer, the taxpayer must either:

- have on file with the CRA Form T1013, "Authorizing Or Canceling A Representative" (for individuals) or RC59 "Business Consent" (for businesses), or
- have authorized a representative through My Account or My Business Account to access their account using the "Represent A Client" service.

## Informal Request For Adjustments

2-109. If a taxpayer disagrees with an assessment or reassessment, the usual first step is to contact the CRA immediately. In some cases the proposed change is the result of a simple error on the part of the taxpayer or a lack of information and can be corrected or resolved through telephone contact or by letter.

## Notice Of Objection

### *General Rules*

2-110. If the informal contact does not resolve the issue in question, a taxpayer has the right to file a notice of objection. The three methods available for filing one are:

- by accessing My Account or My Business Account from the CRA website and selecting the option "Register my formal dispute" (also available through Represent A Client),
- using Form T400A, "Objection – Income Tax Act", or,
- writing a letter to the Chief of Appeals at the relevant Appeals Intake Centre explaining the reasons for your objection.

2-111. For corporations and inter vivos trusts, a notice of objection must be filed within 90 days of the date on the Notice of Assessment or Reassessment. For individuals and testamentary trusts, the rules are more generous. For these taxpayers, the notice of objection must be filed before the later of:

- 90 days from the date on the Notice of Assessment or Reassessment; or
- one year from the filing due date for the return under assessment or reassessment.

**EXAMPLE** An individual required to file on April 30, 2019, files on March 26, 2019. The Notice of Assessment is dated May 14, 2019 and contains a change by the CRA. The Notice of Reassessment is dated August 1, 2020 and contains another change.

**ANALYSIS** A notice of objection related to the Notice of Assessment must be filed before the later of August 12, 2019 (90 days after the date on the Notice) and April 30, 2020 (one year after the filing due date). The deadline would be April 30, 2020, without regard for the fact that the return was actually filed on March 26, 2019. Since the Notice of Reassessment was received after April 30, 2020, the notice of objection for it must be filed by October 30, 2020 (90 days after the date on the Notice).

2-112. When an individual dies after October of the year and before May of the following year, you will recall that the filing date for the return is extended to six months after the date of death, thereby extending the date for filing a notice of objection by the same number of months.

2-113. A taxpayer can request an extension of the filing deadline for the notice of objection. Since many of the disputed issues result from a Notice of Reassessment mailed more than a year after the filing due date of the return, the relevant deadline is then 90 days from the date on the Notice of Reassessment. If the matter is complicated and requires professional help, 90 days may not be sufficient time to respond to the reassessment. The application for an extension must be made within one year of the deadline to file the notice of objection.

2-114. After the notice of objection is received, the CRA is required to reply to the taxpayer:

- vacating the assessment,
- confirming it (i.e., refusing to change it),
- varying the amount, or
- reassessing.

2-115. Unresolved objections are subject to review by the Chief of Appeals. These appeals sections are instructed to operate independently of the assessing divisions and should provide an unbiased second opinion. If the matter remains unresolved after this review, the taxpayer must either accept the CRA's assessment or, alternatively, continue to pursue the matter to a higher level of appeal.

2-116. The CRA has a pamphlet covering the dispute process, Resolving Your Dispute: Objections and Appeal Rights under the Income Tax Act (P148). It contains coverage of the procedures needed to file a Notice of Assessment, including a sample, as well as information on how to proceed with an appeal.

### Rules For Large Corporations

2-117. The CRA appears to believe that it has been the practice of certain corporate taxpayers to delay the dispute process by filing vague objections in the first instance, and subsequently bringing in fresh issues as the appeal process moves forward.

2-118. To prevent this perceived abuse, a corporation must specify each issue to be decided, the dollar amount of relief sought for each issue, and the facts and reasons relied on by the corporation in respect of each issue when filing a notice of objection.

2-119. If the corporation objects to a reassessment or additional reassessment made by the CRA, or appeals to the Tax Court of Canada, the objection or appeal can be only with respect to issues and dollar amounts properly dealt with in the original notice of objection. There is an exception to this general rule for new issues that are raised by the CRA on assessment or reassessment. These limitations are only applicable to "large corporations", defined as a corporation with Taxable Capital Employed In Canada that is in excess of $10 million at the end of the year to which the objection relates.

### Statistics Related To Notices Of Objection

2-120. In 2016, the Auditor General released a report dealing with the effectiveness and timeliness of the objection process. The report covered the fiscal years 2011/12 through 2015/16. During this period a total of 223,739 objections were filed. Some of the results are as follows:

- The total of the amounts in dispute was $13.3 billion.
- Just over 50 percent of the claims were allowed in full or in part, resulting in savings for taxpayers of $6.1 billion.
- The average time to process was 227 days when personal income tax was involved. When corporate income tax was involved, the average time to process was 454 days.
- 78 percent of the objections were related to assessments. The remaining 22 percent resulted from the audit process.

## Exercise Two - 10

**Subject:** Notice Of Objection

Jerry Fall filed his 2019 tax return as required on April 30, 2020. His Notice of Assessment dated May 20, 2020 indicated that his return was accepted as filed. On May 22, 2021, he receives a Notice of Reassessment dated May 15, 2021 indicating that he owes additional taxes, as well as interest on the unpaid amounts. What is the latest date for filing a notice of objection for this reassessment? Explain your answer.

**SOLUTION available in print and online Study Guide.**

## Tax Court Of Canada

### Deadline For Appeal

2-121. A taxpayer who does not find satisfaction through the notice of objection procedure may then proceed to the next level of the appeal procedure, the Tax Court of Canada. Appeals to the Tax Court of Canada must be made within 90 days of the date on the CRA's response to the notice of objection (which would confirm the assessment or reassessment), or 90 days after the notice of objection has been filed if the CRA has not replied. It is not possible to bypass the Tax Court of Canada and appeal directly to the Federal Court level, except in very limited circumstances.

### Informal Procedure

2-122. On appeal to the Tax Court of Canada, the general procedure will automatically apply unless the taxpayer elects to have his case heard under the informal procedure. The informal procedure can be elected for appeals in which the total amount of federal tax and penalty involved for a given year is less than $25,000, or where the loss in question is less than $50,000.

2-123. Advantages of the informal procedure include:

- The rules of evidence remain fairly informal, allowing the taxpayer to represent himself, or be represented by an agent other than a lawyer.
- Under the informal procedure, even if the taxpayer is unsuccessful, he cannot be asked to pay court costs.
- The informal procedure is designed as a fast-track procedure that is usually completed within 6 or 7 months whereas the general procedure may take many years.

2-124. The major disadvantage of the informal procedure is that the taxpayer generally gives up all rights to further appeals if the Court decision is unfavourable.

### General Procedure

2-125. If the general procedure applies, formal rules of evidence must be used, resulting in a situation where the taxpayer has to be represented by either himself, or legal counsel. In practical terms, this means that for cases involving substantial amounts, lawyers will usually be involved.

2-126. Under the general procedure, if the taxpayer is unsuccessful, the Court may require the taxpayer to pay costs to the CRA. Under either procedure, if the taxpayer is more than 50 percent successful (e.g., if he is claiming $10,000 and is awarded more than $5,000), the judge can order the CRA to pay all or part of the taxpayer's costs. However, there is a Tariff structure that can severely limit the costs that can be awarded by the court.

### Appeals By The Minister

2-127. There are situations in which the CRA may pursue a matter because of its general implications for broad groups of taxpayers. The individual taxpayer is given protection from the costs associated with this type of appeal by the requirement that the CRA be responsible for the taxpayer's reasonable legal fees when the amount of taxes payable in question does not exceed $25,000 or the loss in dispute does not exceed $50,000. This is without regard to whether the appeal is successful.

### Resolution

2-128. Prior to the hearing by the Tax Court of Canada, discussions between the taxpayer and the CRA are likely to continue. It would appear that, in the majority of cases, the dispute will be resolved prior to the actual hearing. However, if a hearing proceeds, the Court may dispose of an appeal by:

- dismissing it; or
- allowing it and
  - vacating the assessment,
  - varying the assessment, or
  - referring the assessment back to the CRA for reconsideration and reassessment.

### Federal Court And Supreme Court Of Canada

2-129. Either the CRA or the taxpayer can appeal a general procedure decision of the Tax Court of Canada to the Federal Court of Appeal. The appeal must be made within 30 days of the date on which the Tax Court of Canada makes its decision.

2-130. It is possible to pursue a matter beyond the Federal Court to the Supreme Court of Canada. This can be done if the Federal Court of Appeal refers the issue to the higher Court, or if the Supreme Court authorizes the appeal. These actions will not usually happen unless there are new issues or legal precedents to be dealt with and, as a result, such appeals are not common. However, when tax cases do reach the Supreme Court, they often attract a great deal of public attention.

**We suggest you work Self Study Problem Two-6 at this point.**

## Tax Evasion, Avoidance And Planning

### Tax Evasion

2-131. The concept of tax evasion is not difficult to understand. It is described on the CRA website as follows:

> Tax evasion typically involves deliberately ignoring a specific part of the law. For example, those participating in tax evasion may under-report taxable receipts or claim expenses that are non-deductible or overstated. They might also attempt to evade taxes by wilfully refusing to comply with legislated reporting requirements.
>
> Tax evasion, unlike tax avoidance, has criminal consequences. Tax evaders face prosecution in criminal court.

2-132. There is little ambiguity in this description as it involves deliberate attempts to deceive the taxation authorities. The most common of the offenses that fall under this description of tax evasion is probably the failure to report revenues. This may involve individuals receiving income in the form of cash (common in the home renovation business). Many of the more important cases involve income from assets held offshore.

2-133. You should note the severity of the possible punishments associated with tax evasion. The facts in a 2016 real life example illustrate this point:

> **Ottawa, Ontario, October 19, 2016**... The Canada Revenue Agency (CRA) announced today that, on October 17, 2016, Tania Kovaluk was sentenced in the Superior Court of Justice in Ottawa to 1,825 days (5 years) in jail for deliberately choosing not to pay a court-imposed fine for criminal tax evasion. On November 20, 2012, Kovaluk pleaded guilty to multiple counts related to income tax and GST evasion. She was sentenced to two years and five months in jail, and was fined $887,328, which was payable in full by June 30, 2014. Since she was released from jail she has made no attempt to pay her court-imposed fine. Kovaluk, a dentist, knowingly failed to report $2,578,987 in income she earned from 2003 to 2007, thereby evading $721,617 in federal taxes.

## Tax Avoidance And Tax Planning

### A Fuzzy Concept

2-134. Despite the fact that disputes may arise with respect to its implementation, the concept of tax evasion is clear — tax evasion involves deliberately breaking the law. Working from this concept, it could be argued that any tax arrangement that is within the law should be considered tax planning.

2-135. However, there is a longstanding view within the government that there are tax arrangements that, while they do not break the law, violate the "spirit" of the law. Such transactions are commonly referred to as avoidance transactions. In an attempt to support this view, the CRA website describes the difference between tax planning and tax avoidance as follows:

> Tax avoidance and tax planning both involve tax reduction arrangements that may meet the specific wording of the relevant legislation. **Effective tax planning** occurs when the results of these arrangements are consistent with the intent of the law. When tax planning reduces taxes in a way that is inconsistent with the overall spirit of the law, the arrangements are referred to as **Tax Avoidance**. The Canada Revenue Agency's interpretation of the term "tax avoidance" includes all unacceptable and abusive tax planning. Aggressive tax planning refers to arrangements that "push the limits" of acceptable tax planning.
>
> Tax avoidance occurs when a person undertakes transactions that contravene specific anti-avoidance provisions. Tax avoidance also includes situations where a person reduces or eliminates tax through a transaction or a series of transactions that comply with the letter of the law but violate the spirit and intent of the law. It was to address these latter situations that the general anti-avoidance rule was enacted in 1988.
>
> Tax avoidance results when actions are taken to minimize tax, while within the letter of the law, those actions contravene the object and spirit of the law.

2-136. For many years, the CRA tried to enforce this tax avoidance concept through the use of a "business purpose test". That is, if a transaction had no business purpose other than the avoidance or reduction of taxes, it was not acceptable for tax purposes. However, the courts consistently rejected this concept, leaving the CRA with little ability to enforce what it viewed as tax avoidance. An attempt to solve this problem was put forward in 1988 as a General Anti-Avoidance Rule (GAAR).

## General Anti-Avoidance Rule (GAAR)

### Basic Provisions

2-137. The basic GAAR provision is as follows:

> **Paragraph 245(2)** Where a transaction is an avoidance transaction, the tax consequences to a person shall be determined as is reasonable in the circumstances in order to deny a tax benefit that, but for this section, would result, directly or indirectly, from that transaction or from a series of transactions that includes that transaction.

2-138. The Section goes on to describe an avoidance transaction as follows:

> **ITA 245(3)** An avoidance transaction means any transaction
>
> (a) that, but for this section, would result, directly or indirectly, in a tax benefit, unless the transaction may reasonably be considered to have been undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit; or
>
> (b) that is part of a series of transactions, which series, but for this section, would result, directly or indirectly, in a tax benefit, unless the transaction may reasonably be considered to have been undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit.

2-139. Taken together, these provisions mean that the GAAR will apply to any transaction other than those where there is a bona fide non-tax purpose, or where there is no misuse or abuse of the *Act*. If a transaction is judged to be an avoidance transaction, the consequences may involve:

- The disallowance of a deduction in whole or in part.
- Deductions or losses being allocated to a different person.
- The nature of some payments being re-characterized.
- Some tax effects (e.g., a loss) that might otherwise be recognized being ignored.

2-140. The interpretation of these rules is generally left to lawyers, rather than to accountants. Given this, we will not provide any detailed coverage of this subject in this text. However, GAAR is of sufficient importance that anyone involved in tax work should be aware of the existence of this provision.

# Collection And Enforcement

## Taxpayer Property

2-141. The CRA has enforcement powers under the provisions of ITA 231.1, "Inspections" and ITA 231.2, "Requirement To Provide Documents Or Information".

2-142. Tax officials or other persons authorized by the CRA have the right to enter a taxpayer's place of business, locations where anything is done in connection with the business, or any place where records related to the business are kept. Tax officials may also examine any document of another taxpayer that relates, or may relate to, the information that is, or should be, in the books and records of the taxpayer who is being audited. However, in those cases where the place of business is also a dwelling, the officials must either obtain the permission of the occupant or have a court issued warrant. In this process, the officials may audit the books and records, examine all property, and require that the taxpayer answer questions and provide assistance.

2-143. Seizure of books and records requires a court issued warrant. If this occurs, a taxpayer may apply to have the records returned. Also requiring judicial authorization is demands for information about unnamed persons from third parties. This could include information from the files of the taxpayer's lawyer or accountant. There are additional confidentiality rules in this area that protect solicitor/client communications. However, accountant/client privilege is not protected unless they are part of the solicitor/client privilege. This usually occurs when a lawyer directs the activities of the accountant.

## Collections

2-144. As noted earlier in the Chapter, the due date for the payment of personal income taxes for a taxation year is April 30 of the following year. The due date for corporate income taxes is two months after the corporate year end (three months for qualifying Canadian controlled private corporations). Additional taxes may become payable as a result of an assessment or reassessment. If this is the case, these taxes are due at the time the notice of assessment is mailed.

2-145. Initial collection procedures will not normally extend beyond communicating with the taxpayer about his liability and the related interest that will be charged. In the case of taxes resulting from an assessment or reassessment, the CRA cannot exercise its collection powers until:

- 90 days after the assessment or reassessment date when no objection is filed;
- 90 days from the date of the notice from the CRA appeals division confirming or varying the assessment or reassessment where an objection has been filed and no further appeal has been made; or
- 90 days after a court decision has been made and there are no further appeals.

2-146. If informal procedures fail to result in payment of the tax owing by the defaulter, the CRA can request that a taxpayer owing money to the defaulter make payments to the CRA in settlement of the defaulter's liability. A common example of this would be garnishment of a defaulter's wages to pay income taxes owed. The CRA can go even further and obtain a judgment against a defaulter that can be enforced by seizure and sale of the taxpayer's property.

## Other Penalties

### Examples

2-147. We have previously discussed the penalties associated with the late payment of instalments and the late filing of tax returns. There are a number of other penalties that are specified in tax legislation. Examples of such penalties would be as follows:

**Repeated Failure To Report Income** This penalty applies when there is a failure to report at least $500 in income in the current year, and in any of the three preceding years. The penalty is the lesser of:

- 10 percent of the unreported amount (not the taxes owing); and
- an amount equal to 50 percent of the difference between the understatement of related to the omission and the amount of any tax paid in respect of the unreported amount (e.g., withholdings by an employer).

**False Statements Or Omissions** This penalty applies in cases of gross negligence where there is an intention to disregard the *Income Tax Act*. The penalty is the greater of $100 and 50 percent of the understated tax.

**Evasion** Penalties here range from 50 percent to 200 percent of the relevant tax and, in addition, imprisonment for a period not exceeding two years.

### Tax Advisors And Tax Return Preparers

2-148. Tax preparers who prepare more than 10 returns for a fee are required to register with the CRA and file them electronically. Mandatory electronic filing applies to both the filing of T1 individual returns and T2 corporate returns. Individual taxpayers and volunteers who do not charge a fee to prepare tax returns for others are not required to register for an EFILE number. Tax preparers who do not efile may be charged a penalty of $25 for each paper-filed T1 and $100 for each paper-filed T2.

2-149. Civil penalties for tax advisors and tax return preparers who encourage or assist clients with tax evasive practices are found in ITA 163.2, titled "Misrepresentation of a Tax Matter by a Third Party". The penalty of most concern to accountants is the one for participating in a misrepresentation in the preparation of a return. The penalty is the greater of $1,000 and the penalty assessed on the tax return preparer's client for making the false statement or omission. The penalty on the client is equal to 50 percent of the amount of tax avoided as a result of the misrepresentation. The total amount of the penalty is capped at $100,000, plus the gross compensation to which the tax return preparer is entitled to receive.

2-150. IC 01-1, "Third-Party Civil Penalties", is an extensive Information Circular that contains 18 examples of the application of third-party penalties. While the examples cited in the IC illustrate clear cut abuses, there are many situations in which it is to the taxpayer's advantage to pursue a more aggressive stance in claiming deductions. It is believed that these penalties discourage tax return preparers from suggesting or condoning this type of approach, out of fear that they may be liable for the third party penalties if the returns are audited. In addition, it appears that an increasing number of tax return preparers are refusing to service certain types of high risk clients.

### Promoters Of Abusive Tax Shelters And Tax Planning Arrangements

2-151. The CRA has a number of penalties applicable to tax advisors and promoters of what they consider to be abusive tax shelters and tax planning arrangements. For example, for many years the CRA has been actively pursuing taxpayers participating in "gifting tax shelter schemes" and promoters of these schemes.

2-152. The penalties in this complex area can arise from a number of misdeeds such as participating in a misrepresentation, making or furnishing false or misleading statements and being involved with the development of an "abusive" tax shelter. In addition to promoters, the penalties can apply to a tax advisor who, in the course of providing tax advice, is responsible for and contributes to the design of any of the tax avoidance elements of the arrangement.

**We suggest you work Self Study Problem Two-7 at this point.**

**Additional Supplementary Self Study Problems Are Available Online.**

# Taxpayer Relief Provisions (Fairness Package)

## Basic Rules

2-153. There is a widespread perception that the application of some of the CRA's rules on interest and penalties, as well as certain other rules, can result in individuals and other taxpayers being treated in an unfair manner. Reflecting this concern, a "fairness package" is described in IC 07-1R1, "Taxpayer Relief Provisions". In general terms, the content of IC 07-1R1 is as follows:

**Part I** describes the relevant legislation and limits claims to 10 years from the end of the calendar year in which the tax issue occurred.

**Part II - Guidelines For The Cancellation Or Waiver Of Penalties And Interest** indicates that penalties or interest may be waived in the following situations:

- **Extraordinary Circumstances** - Examples include natural disasters or serious illness.
- **Actions Of The CRA** - Examples here include processing delays and errors in materials made available to the public.
- **Inability To Pay Or Financial Hardship** - Examples here include the need to provide extended payment arrangements or the inability of an individual to provide basic necessities for his family.

**Part III - Guidelines for Accepting Late, Amended, or Revoked Elections** While the *Act* contains numerous elections, there is rarely any provision for revoking, amending, or making them after the specified time period has passed. The Appendix to IC 07-01 provides a fairly long list of prescribed elections for which the CRA has discretionary authority to extend the statutory time limit for their filing, amending, or revoking.

**Part IV - Guidelines For Refunds Or Reduction In Amounts Payable Beyond The Normal Three Year Period** The *Act* sets a three year limitation period from the end of the tax year of an individual to file an income tax return to claim a tax refund and a three year limitation period from the date of the Notice of Assessment to ask for an adjustment to an assessment issued for a previous tax year. The information in Part IV of this IC deals with the CRA's discretion to relieve an individual and a testamentary trust from the limitation period and, in certain circumstances, to accept late requests to give the individual or testamentary trust a refund or reduction in tax.

**Part V - Rules and Procedures When Relief is Granted or Denied** This is a more technical section, setting out the procedures related to granting relief, as well as the procedures associated with administrative and judicial reviews of fairness decisions.

## Application

2-154. Very little has been written about the application of the taxpayer relief provisions. Perhaps the most useful information is a guide that was prepared by the CRA for internal use. This *Taxpayer Relief Guide,* which is available as the result of a request made under the Federal *Access To Information Act*, provides a very extensive discussion of the application of the taxpayer relief provisions. At this time, however, this *Guide* does not appear to be available on the CRA web site.

2-155. We would note that it has become commonplace for decisions made under the authority of the taxpayer relief legislation to be challenged in court through an application for judicial review. This may result in the decision being returned to the CRA for reconsideration. For example, in both Meier v. CRA [2011 DTC 5127] and NRT Technology Corp v. Canada [2013 DTC 5056], the fairness decision of the CRA was overturned and returned to the CRA for consideration.

2-156. We would also note that the CRA has taken a number of steps that are designed to ensure that taxpayers are, in fact, treated fairly. These include the publication of a fairness pledge as well as a taxpayer bill of rights. More information about this subject is available on the CRA website.

# Key Terms Used In This Chapter

2-157. The following is a list of the key terms used in this Chapter. These terms, and their meanings, are compiled in the Glossary located at the back of the Study Guide.

| | |
|---|---|
| Assessment | Notice Of Objection |
| Consent Form | Penalties |
| EFILE | Prescribed Rate |
| Fairness Package | Reassessment |
| GAAR | Small CCPC |
| Information Return | Source Deductions |
| Instalment Threshold | Tax Avoidance |
| Instalments | Tax Court Of Canada |
| My Account (CRA Website) | Tax Evasion |
| Net Tax Owing | Tax Planning |
| NETFILE | Taxpayer |
| Notice Of Assessment | Taxpayer Relief Provisions |

# References

2-158. For more detailed study of the material in this Chapter, we would refer you to the following:

| | |
|---|---|
| ITA 150 | Filing Returns Of Income - General Rule |
| ITA 151 | Estimate Of Tax |
| ITA 152 | Assessment |
| ITA 153(1) | Withholding |
| ITA 156 | Other Individuals (Instalments) |
| ITA 156.1 | Definitions (Instalments) |
| ITA 157 | Payment By Corporation (Instalments) |
| ITA 161 | Interest (General) |
| ITA 162-163.1 | Penalties |
| ITA 163.2 | Misrepresentation Of A Tax Matter By A Third Party |
| ITA 164(1) | Refunds |
| ITA 165 | Objections To Assessment |

*References*

| | |
|---|---|
| ITA 169-180 | Appeals To The Tax Court Of Canada And The Federal Court Of Appeal |
| ITA 220 | Minister's Duty |
| ITA 221 | Regulations |
| ITA 222 | Definitions (Collections) |
| ITA 223 | Definitions (Seizure Of Property) |
| ITA 224 | Garnishment |
| ITA 227 | Withholding Taxes |
| ITA 230 | Records And Books |
| ITA 231.1 | Inspections |
| ITA 231.2 | Requirement To Provide Documents Or Information |
| ITA 261 | Definitions (Functional Currency) |
| ITA 245-246 | Tax Avoidance |
| ITR Part II | Information Returns |
| ITR 4301 | Prescribed Rate of Interest |
| ITR 5300 | Instalments (Individuals) |
| ITR 5301 | Instalments (Corporations) |
| ITR 5800 | Retention Of Books And Records |
| IC 01-1 | Third-Party Civil Penalties |
| IC 07-1R1 | Taxpayer Relief Provisions |
| IC 71-14R3 | The Tax Audit |
| IC 75-6R2 | Required Withholding From Amounts Paid To Non-Resident Persons Providing Services In Canada |
| IC 75-7R3 | Reassessment Of A Return Of Income |
| IC 78-10R5 | Books And Records Retention/Destruction |
| IC 84-1 | Revision Of CCA Claims And Other Permissive Deductions |
| IC 88-2 | General Anti-Avoidance Rule: Section 245 Of The Income Tax Act |
| IC 98-1R7 | Collection Policies |
| S5-F4-C1 | Income Tax Reporting Currency |
| P148 | Resolving Your Dispute: Objection And Appeal Rights Under The Income Tax Act |

# Problems For Self Study (Online)

To provide practice in problem solving, there are Self Study and Supplementary Self Study problems available on MyLab Accounting.

Within the text we have provided an indication of when it would be appropriate to work each Self Study problem. The detailed solutions for Self Study problems can be found in the print and online Study Guide.

We provide the Supplementary Self Study problems for those who would like additional practice in problem solving. The detailed solutions for the Supplementary Self Study problems are available online, not in the Study Guide.

The .PDF file "Self Study Problems for Volume 1" on MyLab contains the following for Chapter 2:

- 7 Self Study problems,
- 5 Supplementary Self Study problems, and
- detailed solutions for the Supplementary Self Study problems.

# Assignment Problems

(The solutions for these problems are only available in the solutions manual that has been provided to your instructor.)

### *Assignment Problem Two - 1*

***(Individual Tax Instalments)***

The following table contains information for Gladys Nite for the three years ending December 31, 2019. The Tax Payable column is her combined federal and provincial Tax Payable. The amounts in the columns titled Case One, Two and Three are the amounts withheld by her employer in three independent cases.

| | Tax Payable | Case One | Case Two | Case Three |
|---|---|---|---|---|
| **2017** | $18,880 | $14,480 | $19,280 | $15,280 |
| **2018** | 20,320 | 19,720 | 14,880 | 16,160 |
| **2019** (Estimated) | 21,760 | 18,640 | 18,560 | 19,440 |

**Required:**

A. For each of the three cases:

- indicate whether instalments are required for the 2019 taxation year. Show all of the calculations required to make this decision;
- in those cases where instalments are required, indicate the amount of the instalments that would be required under the approach used in the CRA's instalment reminder; and
- in those cases where you have calculated the instalments required under the CRA's instalment reminder approach, indicate whether there is a better approach and, if so, calculate the required instalments under that approach.

B. For those Cases where instalments are required, indicate the dates on which the payments will be due.

### *Assignment Problem Two - 2*

***(Instalments, Interest And Penalties For Corporations)***

For both tax and accounting purposes Ledux Inc. has a January 31 year end. Ledux is a publicly traded Canadian company.

For the year ending January 31, 2017, Ledux Inc. had federal Tax Payable of $193,420.

During the following year ending January 31, 2018, the federal Tax Payable was $215,567. While final figures are not available at this time, it is estimated that federal Tax Payable for the year ending January 31, 2019 will be $203,345.

**Required:**

A. Calculate the instalment payments that are required for the year ending January 31, 2019 under each of the alternative methods available. Indicate which of the alternatives would be preferable.

B. If the Company did not make any instalment payments towards its 2019 taxes payable, and did not file its corporate tax return or pay its taxes payable on time, indicate how the interest and penalty amounts assessed against it would be determined (a detailed calculation is not required).

### *Assignment Problem Two - 3*

#### *(Individual Tax Instalments)*

For the three taxation years ending December 31, 2017, 2018, and 2019, assume that Bronson James had the following actual and estimated amounts of federal and provincial Tax Payable withheld by his employer:

| | |
|---|---|
| 2017 | $8,946 |
| 2018 | 9,672 |
| 2019 (Estimated) | 10,476 |

In order to illustrate the calculation of required instalments, consider the following three independent cases. In each case, Bronson's combined federal/provincial Tax Payable is provided.

| Year | Case 1 | Case 2 | Case 3 |
|---|---|---|---|
| 2017 | $ 7,843 | $ 8,116 | $13,146 |
| 2018 | 12,862 | 13,846 | 12,842 |
| 2019 (Estimated) | 14,327 | 13,542 | 13,676 |

**Required**: For each of the three Cases:

- indicate whether instalments are required for the 2019 taxation year;
- in those Cases where instalments are required, calculate the amount of the instalments that would be required under each of the three acceptable methods;
- in those cases where instalments are required, indicate which of the three acceptable methods would be the best alternative; and
- in those Cases where instalments are required, indicate the dates on which the payments will be due.

### *Assignment Problem Two - 4*

#### *(Instalments, Interest And Penalties For Corporations)*

For both tax and accounting purposes Lanterna Inc. has a July 31 year end. Lanterna is a publicly traded Canadian company.

For the three years ending July 31, 2019, it provides the following information with respect to its federal Tax Payable:

| | |
|---|---|
| **2017** | $132,650 |
| **2018** | 141,720 |
| **2019** (Estimated) | 139,460 |

**Required:**

A. Calculate the instalment payments that are required for the year ending July 31, 2019 under each of the alternative methods available. Indicate which of the alternatives would be preferable.

B. If the Company did not make any instalment payments towards its 2019 taxes payable, and did not file its corporate tax return or pay its taxes payable on time, indicate how the interest and penalty amounts assessed against it would be determined (a detailed calculation is not required).

### Assignment Problem Two - 5

#### (Filing Dates)

In addition to interest charges on any late payment of taxes, penalties may be assessed for failure to file a return within the prescribed deadlines. These deadlines vary depending on the taxpayer.

**Required**: Indicate when income tax returns must be filed for each of the following types of taxpayers:

A. Living individuals.
B. Deceased individuals.
C. Trusts.
D. Corporations.

### Assignment Problem Two - 6

#### (Appeals)

Mr. Darcy O'Brien has just received a Notice of Reassessment requesting an additional payment of $72,500 for the 2015 taxation year. He is outraged in that he believes that the CRA is harassing him because of his previous difficulties with the CRA. These previous difficulties resulted in his having to pay both penalties and interest.

He has asked for your services in dealing with the Notice of Reassessment and you agreed to meet with him on March 26, 2019. At this meeting, Mr. O'Brien assures you that his 2015 return was correctly prepared and filed on time, and that there is no reasonable basis for the CRA claim. After he describes the issue, you decide it is likely that his analysis of the situation is correct.

**Required:** Indicate what additional information should be obtained during the interview with Mr. O'Brien and what steps should be taken if you decide to accept him as a client.

### Assignment Problem Two - 7

#### (Tax Preparer's Penalties)

For each of the following independent cases, indicate whether you believe any penalty would be assessed under ITA 163.2 on any of the parties involved. Explain your conclusion.

#### Case 1

In preparing a tax return for one of his established clients, an accountant relies on the financial statements that another accountant has prepared for the client's business income. Nothing in these statements seemed unreasonable.

On audit, the CRA finds that the business income financial statements prepared by the other accountant contained material misrepresentations.

#### Case 2

An accountant is asked to prepare tax return for a new client. The accountant had no previous acquaintance with the individual.

The client provides statements, prepared using the appropriate tax figures, showing a net business income of $45,000. He has no other income. He indicates that, during the current year,

he made a $32,000 contribution to a registered Canadian charity, but has lost the receipt and has requested a duplicate. As it is now April 29, in order to avoid a late filing penalty, the accountant e-files the tax return, claiming a tax credit for the contribution without seeing the receipt.

### *Case 3*

An accountant has been engaged by a new client to use his records to prepare an income statement and to use the information in this statement to prepare a tax return. As part of this engagement, the accountant reviews both the expense and revenue information that has been provided to him by the new client. He finds revenues of $285,000 and expenses of $201,000. The information used to arrive at these figures seems reasonable and, given this, the accountant files the required tax return.

When the client is audited, the CRA finds a large proportion of the expenses claimed cannot be substantiated by adequate documentation and may not have been incurred. Furthermore, it appears that the client has a substantial amount of unreported revenues.

### *Case 4*

An accountant who lives in an expensive neighbourhood notices that the house next door has just been sold. It was listed for $1 million. The accountant introduces himself to the new neighbour and they become friends.

At tax time the friend hires the accountant to prepare his return. The accountant is given a T4 with $25,000 in income reported. Thinking that the gross income is on the low side, the accountant asks if this is all the income he has and the friend replies that it is so. The accountant is still not satisfied with the answer as the income seems to be out of proportion with the living standard of the friend, so he then asks him if he has received money from any source other than his employment and the friend replies that he received a substantial inheritance from his mother last year.

The accountant does not ask any further questions and prepares and files the return. When the friend is audited it is discovered that he has over $200,000 in unreported income.

### *Case 5*

Units in a new limited partnership tax shelter are being sold by a company. The company has established this limited partnership by acquiring a software application in the open market for $100,000. However, the prospectus prepared by the company states that the fair market value of the application is $5,000,000, a value that was supported by an independent appraiser. The tax shelter is registered with the CRA and is available as an investment opportunity in the current year.

On audit, the CRA determines that the $100,000 that was paid for the software application is, in fact, its fair market value on the date of the transfer. In discussing the matter with the independent appraiser, the CRA finds that the appraisal was not prepared using normal valuation procedures. In addition, the appraiser based his work entirely on assumptions and facts that were provided by the company. The appraiser was paid $50,000 for his work.

### *Case 6 (Requires Basic GST/HST Knowledge)*

An accountant is asked to file a HST return for a client who has not kept records of the HST paid or payable on her business purchases for the year. However, the client does have financial statements for her business which, after a brief review, the accountant finds to be reasonable.

In his review, the accountant found that these statements contain large amounts for wages and interest expense, as well as a significant amount of purchases that are zero-rated. (HST is not paid on any of these types of expenses). In preparing the HST return, the accountant applies a factor of 13/113 to all of the expenses shown in the income statement. This results in an overstatement of input tax credits reported on the HST return.

# CHAPTER 3

# Income Or Loss From An Office Or Employment

## Employment Income Defined

### General Rules

3-1. Income or loss from an office or employment (employment income, hereafter) is covered in Part I, Division B, Subdivision a of the *Income Tax Act*. This relatively short Subdivision is made up of Sections 5 through 8, the general contents of which can be described as follows:

**Section 5** contains a definition of employment income.

**Section 6** provides detailed information on what amounts must be included in the determination of employment income.

**Section 7** is a more specialized Section that provides the tax rules associated with stock options granted to employees.

**Section 8** provides detailed information on what amounts can be deducted in the determination of employment income.

3-2. The basic description of employment income is as follows:

**ITA 5(1)** Subject to this Part, a taxpayer's income for a taxation year from an office or employment is the salary, wages and other remuneration, including gratuities, received by the taxpayer in the year.

3-3. While ITA 5(2) contemplates the possibility of a loss from an office or employment, the limited amount of deductions that can be made against employment income inclusions would make such an event very unusual.

3-4. "Employment" is generally defined in ITA 248(1) as the position of an individual in the service of some other person. Similarly, "office" is defined as the position of an individual entitling him to a fixed or ascertainable stipend or remuneration. As will be discussed later, determining whether an individual is, or is not, an employee can be a contentious issue.

3-5. As to what is included in employment income, the terms "salary" and "wages" generally refer to monetary amounts provided in return for employment services. However, the term "remuneration" is somewhat broader and includes any type of reward or benefit

associated with employment services. With the specific inclusion of gratuities, it is clear that employment income includes not only payments from an employer but, in addition, includes any other payments or benefits that result from a taxpayer's position as an employee, without regard to the source of the payment or benefit.

3-6. While it would not be common, it is possible that an individual could receive a payment from an employer that is not related to the quantity or quality of services performed as an employee. For example, if the employee made a personal loan to the employer, any interest paid by the employer to the employee on the loan would not be considered employment income.

## Cash Basis And The Use Of Bonus Arrangements

### *Amounts Received*

3-7. As presented in Paragraph 3-2, the definition of an employee's income states that it is made up of amounts "received by the taxpayer in the year". The use of the term "received" serves to establish that employment income must be reported on a cash basis, not on an accrual basis.

### *Tax Planning Opportunity*

3-8. This fact, when combined with the fact that business income for tax purposes is calculated on an accrual basis (see Chapter 6), provides a tax planning opportunity. A business can declare a bonus to one of its employees and, because it is on an accrual basis, deduct it for tax purposes by simply recognizing a firm obligation to pay the amount. In contrast, the employee who has earned the bonus will not have to include it in employment income until it is actually received.

> **EXAMPLE** A business with a December 31 year end declares a bonus to an employee in December, 2019, but stipulates that it will not be paid until January, 2020.
>
> **ANALYSIS** While the business would get the deduction in 2019, the employee would not include the amount in income until the 2020 taxation year. If the bonus had been paid in December, 2019, the employee would have had to include it in income in 2019. In effect, this arrangement defers the taxation applicable to the employee by one taxation year even though the payment has been deferred by only a few days.

### *Limits On Deferral*

3-9. There are, however, limits to this deferral. ITA 78(4) indicates that, where such a bonus is paid more than 180 days after the employer's year end (note that this is not always December 31), but less than three years, the employer will not be able to deduct the amount until it is paid.

> **EXAMPLE** An employer with a June 30 year end declares a bonus for an employee on June 30, 2019 that is payable on January 1, 2020.
>
> **ANALYSIS** As January 1, 2020 is more than 180 days after the employer's year end on June 30, 2019, the employer will not be able to deduct the bonus in the fiscal year ending June 30, 2019. It will have to be deducted in the fiscal year ending June 30, 2020.

3-10. A different situation can arise when a "bonus" will not be paid until more than three years after the end of the calendar year in which the employee's services were rendered. In this case, the "bonus" may become a "salary deferral arrangement", resulting in the employee being taxed on the relevant amounts in the calendar year in which the services were rendered. The employer deducts the bonus in the fiscal year it is declared. This type of arrangement is discussed in more detail in Chapter 10, Retirement Savings And Other Special Income Arrangements.

3-11. The tax consequences associated with the three types of bonus arrangements are summarized in the following Figure 3-1:

**Figure 3 - 1 Bonus Arrangements**

| Type Of Bonus Arrangement | Tax Consequences |
|---|---|
| **Standard Bonus**<br>(Paid within 180 days of the employer's business year end.) | Employer deducts when declared.<br>Employee includes when received. |
| **Other Bonus**<br>(Paid more than 180 days after the employer's business year end, but prior to 3 years after December 31 of the year in which the bonus was earned.) | Employer deducts when paid.<br>Employee includes when received. |
| **Salary Deferral Arrangement**<br>(Paid more than 3 years after December 31 of the year in which services were rendered.) | Employer deducts when declared.<br>Employee includes when services rendered. (See Chapter 10) |

## Exercise Three - 1

**Subject:** Bonus

Neelson Inc. has a September 30 year end. On August 1, 2019, it declares a bonus of $100,000 payable to Mr. Sam Neelson, an executive of the Company. The bonus is payable on May 1, 2020. Describe the tax consequences of this bonus to both Neelson Inc. and Mr. Neelson.

**SOLUTION available in print and online Study Guide.**

**We suggest you work Self Study Problem Three-1 at this point.**

## Net Concept

3-12. Employment income is a net income concept. That is, it is made up of both inclusions (e.g., salaries and wages) and deductions (e.g., registered pension plan contributions and union dues). In conjunction with this, we would point out that the deductions that are described in ITA 8 can only be deducted against employment income inclusions. Given the limited deductions available in the determination of employment income, it would be very rare for these deductions to exceed the inclusions.

3-13. If an employment loss were to occur, the excess ITA 8 deductions could not be applied against any other source of income. However, if other sources of income are available, the same result can be accomplished by deducting the net employment loss under ITA 3(d) as per the calculation of Net Income For Tax Purposes that is described in Chapter 1.

**EXAMPLE** An individual has employment income of $3,000 and employment expenses of $4,500, resulting in a net employment loss of $1,500. His only other source of income is $20,000 in interest income. He has no Subdivision e deductions.

**ANALYSIS** The individual's Net Income For Tax Purposes would be calculated as follows:

| | |
|---|---|
| Income Under ITA 3(a) | $20,000 |
| Losses Under ITA 3(d) | ( 1,500) |
| Net Income For Tax Purposes | $18,500 |

# Employee Versus Self-Employed

## Introduction

3-14. An individual doing work for an organization will be undertaking this activity in one of two possible roles. He may be working as an employee. If this is the case, he is earning employment income and is subject to the rules discussed in this Chapter.

3-15. In contrast, he may be working as a self-employed individual, often referred to as an independent contractor. From the point of view of the organization using the individual's services, such arrangements are often referred to as contracting out. The payments made to such self-employed individuals are classified as business income and are subject to the rules that are covered in Chapter 6, Business Income.

3-16. This distinction is of considerable importance, both to the individual worker and to the organization using his services. Given this importance, the following material describes the tax features of these alternatives, both from the point of view of the worker and from the point of view of the organization using his services.

3-17. In terms of tax planning, structuring a working relationship to achieve the desired classification of the individual doing the work may result in tax avoidance for both parties. For the worker, being classified as a self-employed individual will generally result in larger deductions against income, thereby reducing Tax Payable. From the point of view of the organization using the individual's services, the independent contractor classification can reduce the costs of using those services.

## Employee Perspective

### *Deductions Available*

3-18. As will be discussed later in this Chapter, an individual's ability to deduct expenses from employment income is quite limited when compared to self-employed individuals. If an individual is self-employed, any income that he earns is classified as business income, making it eligible for the wider range of deductions that is available under the business income provisions of the *Income Tax Act*. For example, a self-employed professional can generally deduct the costs of driving to work. If this individual were classified as an employee, this deduction would typically not be available.

### *CPP Contributions*

3-19. If an individual is an employee, his employer will be required to withhold a portion of his pay for Canada Pension Plan (CPP) contributions and Employment Insurance (EI) premiums. With respect to CPP contributions, for 2019 both the employee and the employer are required to contribute 5.1 percent of up to $57,400 of gross wages reduced by a basic exemption of $3,500. This results in maximum contributions by both the employee and employer of $2,749, or a total of $5,498.

3-20. In contrast, if an individual is self-employed, there will be no withholding of CPP from the amounts received as business income. However, this does not mean that this individual can escape these costs. A self-employed individual must make contributions on the same basis as an employee. Further, self-employed individuals are required to pay both an employee share and an employer share, resulting in a potential maximum payment of $5,498. We would note that, despite the larger contributions required of self-employed individuals, the pension benefits will be the same as for the employed individual.

3-21. As noted in Chapter 2, CPP amounts for the self-employed are collected by the CRA. They are calculated on the T1 tax return where they become part of the amount owing. Further, the CRA includes them in the instalment base when instalments are required which means that they may be a factor in determining the size of quarterly instalments. This could be viewed as a modest advantage of being self-employed as there is some deferral of the required CPP payments, as compared to their payment through payroll deductions.

3-22. However, any benefit resulting from deferral of the CPP payments is clearly offset by the fact that the self-employed individual has to pay double the CPP contributions (both the employee and the employer share) with no higher future pension benefit than employees. There is clearly an overall disadvantage to the self-employed individual.

### EI Premiums

3-23. With respect to EI premiums, the amount that will be withheld from employee earnings amounts to 1.62 percent of the first $53,100 in gross wages, with a maximum annual value of $860. The employer is assessed 1.4 times this amount, a maximum of $1,204. This represents an effective rate for the employer of 2.268 percent.

3-24. Employees are generally required to participate in the EI program. One exception is for employees owning more than 40 percent of the voting shares of the employer. In that case, since no EI can be collected, no EI premiums are paid. The EI rules are complex which can make the determination of insurable employment difficult, especially in the case of an owner-manager employing family members. A non-arm's length employee (such as an adult child or a spouse) would only be eligible for participation in the EI program if it is reasonable to conclude that the owner would have hired an arm's length person under a similar contract of employment.

3-25. Self-employed individuals can opt into the EI program on a voluntary basis for special (restricted) EI benefits, such as maternity benefits. They must opt in at least 12 months prior to making a claim, but once they opt in, they are committed for the taxation year. Further, if a claim is made under this program, the individual is committed for life, or until they stop being self-employed. The good news is that self-employed individuals do not have to pay the employer's share of EI premiums. This means the maximum cost for 2019 would be $860.

3-26. As is the case with CPP payments for self-employed individuals, EI premiums for self-employed individuals are collected by the CRA. This means that payments are paid through instalments or on the balance due date for the return, thereby providing a small amount of deferral. More importantly, with participation voluntary, a self-employed individual can choose whether or not to participate in this program. Since the self-employed individual does not pay the employer's share of the EI (unlike the situation with the CPP), the EI rules appear to be advantageous to self-employed individuals who are eligible.

### Fringe Benefits

3-27. A significant disadvantage of being classified as an independent contractor rather than an employee is the fact that independent contractors do not receive fringe benefits. An employee may receive a wide variety of benefits such as dental and drug plans, membership in a registered pension plan, vacation pay, or life insurance coverage. Such benefits have a significant value, in some cases adding as much as 20 percent to an employee's remuneration. Further, even if the self-employed individual were willing to pay for such benefits, some benefits may not be available to a single individual at a reasonable cost (e.g., extended medical coverage). In any case, a self-employed individual will have to receive significantly higher basic remuneration to be in the same economic position as an individual working as an employee who has generous benefits.

### Opportunity For Tax Evasion

3-28. While we certainly do not condone this, as a practical matter, in some situations, being self-employed can offer significantly larger opportunities for tax evasion. There are stringent reporting requirements that make it difficult for an employee to avoid detection if he fails to report employment income.

3-29. In contrast, self-employment income is sometimes received partially or wholly in cash, depending on the clients. Usually when cash is received, the work is being done for an individual who cannot deduct the cost of the work and does not require a receipt to be issued. A common example of this would be an individual who hires a self-employed contractor to do renovations on his principal residence and pays cash to avoid paying the HST.

3-30. If the self-employed individual is willing to evade income and sales taxes by not reporting these revenues, then the lack of income tax withholding on self-employment earnings becomes a permanent reduction in taxes. Although it is clearly illegal, for some individuals, not reporting earnings received in cash is one of the main motivations behind being self-employed.

### Conclusion

3-31. As the preceding indicates, the desirability of self-employed status is not clear cut. For an individual with limited deductible expenses, self-employment may not be advantageous from an economic point of view. Alternatively, if an individual's work is such that large amounts of business expenses are generated, it is probably desirable to be taxed as a self-employed contractor.

3-32. Non-tax advantages could include the ability to set work schedules and the freedom to choose the amount and type of work accepted. The added cost of accounting for the business and the implications of the GST/HST would also have to be considered. As noted in Chapter 21, in most cases, a self-employed individual would have to register for the GST/HST if he is not a small supplier.

## Employer Perspective

3-33. There are several advantages to a business from using the services of self-employed individuals as opposed to employees. One of the major advantages associated with the hiring of these independent contractors (a.k.a. contracting out) is that the employer avoids payments for Canada Pension Plan (CPP), Employment Insurance (EI), Workers' Compensation, and Provincial Health Care (where applicable).

3-34. The amounts involved here are consequential. CPP and EI payments alone can add more than 7 percent to the wage costs. Provincial payroll taxes can push the total of these costs above 10 percent of wage costs. Further cost savings result from the fact that the employer will avoid the administrative costs associated with having to withhold and remit income taxes and the employee's share of CPP and EI payments.

3-35. Also in favour of using independent contractors is the fact that the business will avoid the costs of any fringe benefits that it normally extends to its employees. A less measurable benefit is that employers are freed from ongoing commitments to individuals because there is generally no long-term contract with self-employed workers.

3-36. An additional and less direct advantage of using independent contractors is that the business is not legally responsible for their work. If an employee does work that results in some type of legal liability for damages, it is the employer that will be responsible for any costs that arise. In contrast, if such work is carried out by an independent contractor, the organization may escape any legal responsibility.

3-37. Given all of these advantages, it is not surprising to find more businesses contracting out in order to control labour costs and limit liability.

## Making The Distinction

### Intent

3-38. The general approach to distinguishing between an employee and an independent contractor is the question of whether an employer/employee relationship exists. As there is no clear definition of employer/employee relationships, disputes between taxpayers and the CRA are very common. To avoid such disputes, and to assist taxpayers in determining whether or not an individual is an employee, the CRA provides a Guide titled "Employee Or Self-Employed?" (RC4110).

3-39. As described in this Guide, the first step in making this distinction is to determine the intent of both parties. Both the worker and the payer must be clear as to whether there is a contract of service (employee/employer) or alternatively, a contract for services (business relationship). This intent may or may not be in the form of a written agreement.

### Other Factors - Employee Vs. Self-Employed

3-40. In many cases, the intent is clear. However, the worker and payer must ensure that their intent is reflected in the actual terms and conditions of their relationship. In making this determination, the Guide indicates that the following factors will be considered by the CRA:

**Control** In an employer/employee relationship, the employer usually controls, directly or indirectly, the way the work is done and the work methods used. The employer assigns specific tasks that define the real framework within which the work is to be done.

**Ownership Of Tools And Equipment** In an employer/employee relationship, the employer usually supplies the equipment and tools required by the employee. In addition, the employer covers the following costs related to their use: repairs, insurance, transport, rental, and operations (e.g., fuel).

In some trades, however, it is customary for employees to supply their own tools. This is generally the case for garage mechanics, painters, and carpenters. Similarly, employed computer scientists, architects, and surveyors sometimes supply their own software and instruments.

**Ability To Subcontract Or Hire Assistants** If the individual must personally perform the services, he is likely to be considered an employee. Alternatively, if the individual can hire assistants, with the payer having no control over the identity of the assistants, the individual is likely to be considered self-employed.

**Financial Risk** In general, employees will not have any financial risks associated with their work. In contrast, self-employed individuals can have risk and can incur losses. Responsibility for fixed monthly costs is a good indicator that an individual is self-employed.

**Responsibility For Investment And Management** If the individual has no capital investment in the business of the payer and no presence in management, he is likely to be considered an employee. Alternatively, if the individual has made an investment and is active in managing his business, he should be considered self-employed.

**Opportunity For Profit** In an employer/employee relationship, the employer alone normally assumes the risk of loss. The employer also usually covers operating costs, which may include office expenses, employee wages and benefits, insurance premiums, and delivery and shipping costs. The employee does not assume any financial risk, and is entitled to his full salary or wages regardless of the financial health of the business.

Correspondingly, an employee will have little or no opportunity for profit. While there may be productivity bonuses for exceptional work, such amounts are not generally viewed as profit.

3-41. The CRA Guide includes a long list of indicators for each of the preceding factors that could affect whether an individual was considered an employee or self-employed. This Guide can be quite helpful if more detailed information in this area is required.

3-42. We would point out that it is extremely important for a business to be sure that any individual who is being treated as a self-employed contractor qualifies for that status. Actions that can be taken to ensure self-employed status for the individual include:

- Having the individual register for the GST.
- Having the individual work for other businesses.
- Having the individual advertise his services.
- To the extent possible, having the individual cover his own overhead, including phone service, letterhead, equipment, and supplies.
- Having the individual prepare periodic invoices, preferably on an irregular basis.
- Having a lawyer prepare an independent contractor agreement.
- If feasible, having the individual incorporate.

### Request A CPP/EI Ruling

3-43. A failure to correctly determine whether a worker should be considered an employee or, alternatively, self-employed, could prove to be very costly to a business using the services of that individual. It is possible that, if the CRA judges the individual to be an employee, the business could be held liable for CPP and EI amounts that should have been withheld from the individual's earnings, as well as the employer's share of these amounts.

3-44. As evidenced by the large number of court cases involving this issue, it is clear that wrong classifications are not uncommon. A fairly reliable way of avoiding this problem is to request a CPP/EI ruling from the CRA. Such a ruling can be requested either by the business or the worker by sending a letter, or completing Form CPT1, *Request for a Ruling as to the Status of a Worker Under the Canada Pension Plan and/or the Employment Insurance Act*.

**We suggest you work Self Study Problem Three-2 at this point.**

# Inclusions - Employee Benefits

## Basic Concepts

3-45. As noted in the Employer's Guide, "Taxable Benefits And Allowances" (T4130), a benefit arises if an employer pays for, or gives something, that is personal in nature:

- directly to an employee; or
- to a person who does not deal at arm's length with the employee (e.g., a spouse, child or sibling).

3-46. This would include any goods or services that the employer arranges for a third party to give to an employee, as well as any allowance or reimbursement for an employee's personal expenses.

3-47. It would not include reimbursement for employment related expenses, nor would it include reasonable allowances to cover employment related expenses. For a more complete discussion of allowances, see the later section in this chapter that deals with this subject beginning at Paragraph 3-125.

3-48. As such, benefits may be taxable or non-taxable. To the extent a benefit is taxable, it must be included in employment income. As the name implies, non-taxable benefits will not be included in employment income.

3-49. Segregation of benefits into taxable and non-taxable amounts is a fairly complex process, involving both legislative provisions and administrative practices. As a result, employee benefit planning is an important component of any large tax practice.

3-50. The amount to be included in employment income is, in general, its fair market value. If GST, PST, or HST is applicable, these amounts would be included in the amount that is added to employment income. This is discussed beginning at Paragraph 3-77.

# Inclusions - Salaries And Wages

3-51. We have noted that ITA 5 specifies that employment income includes salaries, wages, and other remuneration. When only salaries or wages are involved, there is little need to elaborate on employment income inclusions. Such amounts clearly must be included in the determination of employment income and, as the amounts are monetary in nature, there are no issues associated with their valuation.

# Inclusions - Non-Salary Benefits

## Introduction

3-52. If salaries and wages were the only benefits provided by employers, this would be the shortest and least complex chapter in this text. However, this is not the case. Employers use a wide variety of other benefits, commonly referred to as fringe benefits.

3-53. There are three basic reasons for using these alternative forms of compensation:

**Tax Considerations** Different benefits have different tax consequences for employees. Through careful planning, an employee's tax bill can be reduced, often at no cost to the employer. An example of this would be the provision of private health care which can be received by employees on a tax free basis.

**Employee Motivation** Employers believe that some forms of compensation motivate employees to apply greater effort to their employment duties, e.g., the granting of stock options. These securities only have value if the market value of an employer's stock goes up. Given this, it is thought that employees will work harder towards increasing the value of the company's stock if they are granted such options.

**Employee Retention** Studies show that properly planned non-salary benefits play a major role in employee retention. For example, an employee who uses employer provided day care would be more inclined to reject a job offer from a competitor who doesn't offer day care even though the monetary compensation would be higher.

3-54. While these are worthy objectives, they significantly complicate the determination of the appropriate values to be included in employment income. In addition to determining which benefits are taxable, there are often issues associated with the determination of the value that should be attached to these non-salary benefits.

3-55. Some guidance in this area is provided by the content of ITA 6, *Inclusions*. However, this legislative guidance does not resolve many of the issues that are associated with fringe benefits and, as a consequence, additional non-legislative guidance is required. We will give fairly detailed attention to both the legislative guidance found in ITA 6, as well as to the other sources that are relevant to the determination of employment income.

## Legislative Guidance

### *ITA 6(1)*

3-56. ITA 6(1) is the largest subsection in ITA 6. As such it contains a number of paragraphs which list specific items that must be included in employment income. The more important are as follows.

**ITA 6(1) Inclusions**

- ITA 6(1)(b) Amounts received as an allowance for personal or living expenses.
- ITA 6(1)(c) Director's or other fees.
- ITA 6(1)(d) Allocations under profit sharing plans.
- ITA 6(1)(e) Standby charge for automobiles.
- ITA 6(1)(f) Wage loss replacement plans, provided they are received on a periodic basis and are intended to replace employment income.
- ITA 6(1)(g) Employee benefit plan benefits.
- ITA 6(1)(h) Allocations under employee trusts.
- ITA 6(1)(i) Salary deferral arrangement payments (to the extent they have not previously been included in income).
- ITA 6(1)(j) Reimbursements and awards.
- ITA 6(1)(k) Automobile operating expense benefit.

3-57. Accompanying these specific inclusions, ITA 6(1)(a) notes a number of items that can be received without being included in employment income. The more important of these are as follows:

**ITA 6(1)(a) Exclusions**

- Employer's contributions to:
  - registered pension plans;
  - group sickness or accident insurance plans, provided that any benefits received under the plan will be taxed under ITA 6(1)(f);
  - private health services plans;
  - supplementary unemployment benefit plans;
  - deferred profit sharing plans;
  - employee life and health trusts.
- Counseling services related to the mental or physical health of the employee or a related individual, or related to re-employment or retirement of the employee.
- Benefits under a retirement compensation arrangement, employee benefit plans (e.g. death benefit plans), and employee trusts. However actual payments or allocations from such plans or arrangements are taxable elsewhere.
- Benefits resulting from reduced tuition provided to the children of teachers at private schools, provided the teacher is dealing at arm's length with the school and the reduction is not a substitute for salary or other remuneration from the school.

**Note** If you were to read ITA 6(1)(a), you would find that the listed exclusions include both group term life insurance, as well as benefits related to automobiles. This gives the illusion these items are not taxable benefits. However, this is not the case. In a somewhat awkward approach to this issue, these benefits are excluded under ITA 6(1)(a), but included under other provisions. Automobile benefits are included under ITA 6(1)(e) and (k) as listed in the following paragraph, and group term life insurance premiums are included under ITA 6(4).

### *Other ITA 6 Inclusions*

3-58. As noted, ITA 6(1) includes fairly long lists of inclusions and exclusions. In contrast, the other subsections of ITA 6 deal only with inclusions in employment income. The more important of these are as follows:

- ITA 6(2) and (2.1) **"Reasonable Standby Charges".**
- ITA 6(3) and (3.1) **"Payments By Employer To Employee"**, which requires the inclusion of amounts paid either immediately before employment begins, or subsequent to the period of employment.
- ITA 6(4) **"Group Term Life Insurance".**
- ITA 6(6) **"Employment At Special Work Site Or Remote Location".**
- ITA 6(7) **"Cost Of Property Or Service"**, which requires the addition of applicable GST/HST/PST to the amount of some taxable benefits.
- ITA 6(9) **"Amount In Respect Of Interest On Employee Debt".**
- ITA 6(11) **"Salary Deferral Arrangements"**.
- ITA 6(15) and (15.1) **"Forgiveness Of Employee Debt And Forgiven Amount"**, which require that employee debt forgiven by an employer must be included in employment income.
- ITA 6(16) through (18) **"Disability Related Employee Benefits"**
- ITA 6(19) through (22) **"Housing Loss And Eligible Housing Loss"** limit the amount that can be reimbursed on a tax free basis to an employee who has suffered a housing loss as the result of a required move.

3-59. Most of these items will be covered in more detail later in this Chapter or in other Chapters of the text.

## Non-Legislative Guidance

### Sources

3-60. While it appears extensive, the guidance in ITA 6 has not been adequate to guide employers in making the distinction between taxable and non-taxable benefits. Because of this, the CRA provides a significant amount of additional guidance.

3-61. For many years, this guidance was found in IT-470, "Employee's Fringe Benefits". In 2017, this IT Bulletin was replaced by IT Folio S2-F3-C2, "Benefits And Allowances Received From Employment".

3-62. This Folio was a poorly written document that provided less clarity than the IT Bulletin that it replaced. In addition, it contained an unintended change in policy that resulted in the potential taxation of discounts provided to employees by their employers. After much public outcry resulting from this change, the CRA indicated that this was not the department's intention. This ultimately resulted in the withdrawal of this Folio and an indication that taxpayers should look to the CRA Employers' Guide, "Taxable Benefits And Allowances" (T4130). In our view, the Guide is far more useful than IT Folio S2-F3-C2 in clarifying taxable vs. non-taxable benefits. The material which follows is largely based on the content of the Employers' Guide.

### Specific Items

3-63. What follows is a description of the various benefits that are discussed in the Employers' Guide. The benefits are listed in alphabetical order. In some cases, the specific item will be discussed in more detail in a later section of this Chapter. We would also note that the descriptions here are very general. If you are dealing with a real world situation, you should consult the detailed information provided in the Employers' Guide.

**Automobile Benefits** When an employee is allowed to make personal use of an automobile that is provided by his employer, a taxable benefit must be recorded. The determination of these benefits is complex and will be covered in a separate section of this Chapter beginning at Paragraph 3-79.

**Board And Lodging** If an employer provides an employee with free board or lodging, its fair market value must, in general, be treated as a taxable benefit. If the board or lodging is subsidized rather than free, the fair market value will be reduced by any amounts paid by the employee.

The major exceptions to this general rule are as follows:

- Board or lodging provided at a **special work site**. A special work site is defined as an area where temporary duties are performed by an employee who keeps a self-contained domestic establishment at another location as his or her principal place of residence. Because of the distance between the two areas, the employee is not expected to return daily from the work site to his or her principal place of residence.
- Board or lodging provided at a **remote work site**. A remote work site is defined as remote when it is 80 kilometers or more from the nearest established community with a population of at least 1,000 people.

Board or lodging provided at these sites is not considered to be a taxable benefit.

**Cell Phone And Internet Benefits** If an employee makes some personal use of an employer provided cell phone or employer provided internet services, a pro rata share of the cost is considered a taxable benefit.

**Employer Provided Child Care** If an employer provides, at his place of business, child care that is not available to the general public, it is not considered to be a taxable benefit.

**Discounts On Merchandise** In general, if an employer provides discounts on merchandise, it is not considered a taxable benefit. However, the discounts must be available to all employees and the discounted price cannot be below cost.

**Education Related Benefits** There are several types of benefits that relate to education.

- If an employer provides an allowance for an employee's children, the allowance will be included in the employee's income.
- If an employer pays the tuition for a course that is directly related to the recipient's employment, it is not considered a taxable benefit.
- If an employer pays the tuition for a course that is related to general business, it is not considered to be a taxable benefit.
- If an employer pays the tuition for a course that is of personal interest to the employee, it is considered to be a taxable benefit.
- If an employer provides free or reduced tuition to a member of an employee's family, it will generally be included in the family member's income, rather than the income of the employee.

**Gifts, Awards and Long-Service Awards** Cash and near cash gifts and rewards are always taxable benefits. Non-cash gifts and non-cash awards to an arm's length employee, regardless of number, will not be taxable to the extent that the total aggregate value of all non-cash gifts and awards to that employee is less than $500 annually. The total value in excess of $500 annually will be taxable.

Gift certificates are considered near cash awards and taxable. Further, gifts with an immaterial value e.g., a coffee mug, can be ignored.

A separate non-cash long service/anniversary award, to the extent its total value is $500 or less, will not be considered a taxable benefit. The value in excess of $500 will be taxable. In order to qualify, the anniversary award cannot be for less than 5 years of service, or for 5 years since the last long service award had been provided to the employee.

In contrast, a performance related award is considered to be a reward and a taxable benefit.

**Insurance** Because of the many issues involved with various types of insurance, coverage of insurance requires a separate section in this Chapter which begins at Paragraph 3-143.

**Employee Loans** The complications associated with employee loans requires a separate section in this Chapter which begins at Paragraph 3-149.

**Loyalty And Other Points Programs** Loyalty points (e.g., Aeroplan points) that were earned through employment activity are not considered to be a taxable benefit provided:

- the points are not converted to cash;
- the plan is not an alternative form of remuneration; and
- the plan is not for tax avoidance purposes.

**Meals** In general, reimbursing employees for meals consumed when they are required to work overtime does not create a taxable benefit.

If an employer provides subsidized meals to employees, their value is not considered to be a taxable benefit, provided the employee pays a reasonable amount for the benefit.

**Medical Expenses** When an employer pays for an employee's medical expenses, it is considered to be a taxable benefit.

**Moving Expenses** Employer payments for most types of employee moving expenses does not create a taxable benefit. This subject is discussed more completely in Chapter 9 of this text.

**Parking** Employer provided parking is, in general considered to be a taxable benefit. Exceptions to this include:

- Parking for employees with disabilities.
- Parking for employees who regularly require a car to carry out their employment duties.
- Scramble parking (e.g., parking at a site where there are significantly fewer spaces than the number of employees who use them).

**Pooled Registered Pension Plans** Employer contributions to these plans are not considered to be a taxable benefit.

**Premiums For Provincial Health Care** If an employer pays these premiums for an employee, the payments are considered to be a taxable benefit.

**Premiums For Private Health Care** Employer payment of such premiums does not create a taxable benefit.

**Professional Membership Dues** If the employer is the primary beneficiary of the dues, there is no taxable benefit (e.g., membership in the organization is a condition of employment). If the employee is the primary beneficiary, the payment of such dues creates a taxable benefit.

**Recreational Facilities And Club Dues** Employer payment of these items does not result in a taxable benefit in the following situations:

- Provision of an in-house facility that is available to all employees.
- An arrangement where an employer contracts with a facility and then makes it available to all employees.
- The employer provides individual employees with memberships to a facility and the employer is the primary beneficiary of its use.

Otherwise, payments for these items creates a taxable benefit. A complicating factor in tax planning for this benefit is discussed beginning in Paragraph 3-70.

**Stock Options** Because of the complexity related to these benefits, this Chapter contains a separate section dealing with employee stock options beginning at Paragraph 3-157.

**Social Events** Employer provided social events are not a taxable benefit provided:

- they are available to all employees; and
- they cost less than $150 per person.

If the cost is more than $150 person, the full cost, including the first $150 becomes a taxable benefit.

**Spousal Travel Expenses** Employer payment of these costs creates a taxable benefit unless:

- the spouse was along at the employer's request; and
- the spouse was mostly engaged in business activities during the trip.

**Tax-Free Savings Accounts (TFSAs)** If an employer makes a contribution to an employee's tax-free savings account, it is a taxable benefit.

**Tickets To Events** In general, the value of employer provided tickets to events is considered a taxable benefit unless there is a business reason for the employee to attend the event.

**Tool Reimbursement** If an employer reimburses an employee for tools used in his employment activities, it is considered a taxable benefit.

**Transit Passes** In general, the provision of transit passes to employees creates a taxable benefit. An exception to this would be transit passes to employees of a transit company.

**Travel Allowances** Because of the complexity related to allowances, this Chapter contains a separate section dealing with these benefits. It begins at Paragraph 3-125.

**Uniforms Or Special Clothing** The provision of uniforms or special clothing does not create a taxable benefit provided:

- the employer supplies the employee with a distinctive uniform that must be worn while carrying out employment duties; or
- the employer provides the employee with special clothing to protect him from hazards associated with carrying out employment duties.

## Exercise Three - 2

**Subject:** Gifts To Employees

During the current year, Jeffrey's employer provides him with a number of gifts and awards. Describe the tax consequences for Jeffrey that result from each of the following gifts and awards.

| Gift | Fair Market Value |
|---|---:|
| T-shirt with employer logo | $ 15 |
| Birthday gift (gift certificate at The Bay) | 75 |
| Reward for exceeding sales targets | 400 |
| 10 year anniversary award (Seiko watch) | 275 |
| Wedding gift (crystal vase) | 300 |
| Weight loss award (tickets to sporting event) | 250 |
| Holiday season gift (gourmet food basket) | 150 |

## Exercise Three - 3

**Subject:** Employee Benefits

John Nilson is an employee of a high end furniture store. During the current year, John receives a number of benefits from his employer. Describe the tax consequences for John that result from receiving each of the following benefits.

- A 35 percent discount on merchandise with a total value of $10,000.
- Reimbursement of $2,000 in tuition fees for a course in creative writing.
- Business clothing with a value of $8,500 to be worn during working hours. (John's employer felt he needed a better image in dealing with clients.)
- A set of china on the occasion of John's wedding anniversary costing $450, including taxes.
- A private health care plan for John and his family. The employer pays an annual premium of $780 for this plan.

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## Tax Planning Considerations

### Salary The Benchmark

3-64. As previously discussed, some of the benefits provided to employees are fully taxable while other benefits can be extended without creating a taxable benefit. This has important implications in planning employee compensation.

3-65. As the bulk of compensation for most employees is in the form of wages or salaries, such payments provide the benchmark against which other types of compensation must be evaluated. From an income tax point of view, these benchmark payments are fully deductible to the employer in the year in which they are accrued and fully taxable to the employee in the year in which they are received. There is no valid tax reason for using a type of fringe benefit that has these same characteristics.

3-66. For example, if an employer rewards a valued employee with a holiday trip for achieving a sales goal, the cost of the trip will be fully deductible to the employer. Further, the trip's cost will be fully taxable to the employee on the same basis as if the amount had been paid in the form of additional salary. This means that, while there may be a motivational reason for using a holiday trip as a form of compensation, there is no significant income tax advantage in doing so.

### Tax Avoidance

3-67. The most attractive form of non-salary compensation involves benefits that are deductible to the employer, but are received tax free by the employee. For example, as private health care benefits are not taxable, an employer can provide employees with a dental plan without creating any additional tax liability for the employee.

3-68. From a tax point of view, this type of compensation should be used whenever practical, provided it is desirable from the point of view of the employee. For example, although providing a dental plan to an employee is a tax free benefit, if the employee's spouse has already been provided with an identical family dental plan by her employer, this benefit is of no value to the employee.

### Tax Deferral

3-69. Also attractive are those benefits that allow the employer to deduct the cost currently, with taxation of the employee deferred until a later period. We have already considered an example of this involving the use of bonus arrangements. A further important example of this would be contributions to a registered pension plan. The employer can deduct the contributions in the period in which they are made, while the employee will not be taxed until the benefits are received in the form of pension income. This will usually involve a significant deferral of taxation for the employee.

### Recreational Facilities And Club Dues

3-70. In the preceding cases, the tax planning considerations are very clear. There are no tax advantages associated with benefits that are fully and currently taxable to the employee. In contrast, advantages clearly arise when there is no taxation of the benefit, or when the taxation of the employee is deferred until a later point in time.

3-71. There is, however, a complicating factor in the case of certain employer provided recreational facilities or employer payment of club dues. While in some cases, such benefits are not taxable to the employee, the employer is not allowed to deduct the cost of providing such benefits (see Chapter 6 for a more detailed description of these rules). This means that the advantage of no taxes on the employee benefit is offset by the employer's loss of deductibility.

3-72. Whether this type of benefit is tax advantageous has to be evaluated on the basis of whether the tax savings to the employee are sufficient to offset the extra tax cost to the employer of providing a non-deductible benefit. The decision will generally be based on the relative tax rates applicable to the employee and the employer. If the employee's tax rate is higher than the employer's, this form of compensation may be advantageous from a tax point of view. There are also other non-tax factors that may be important, such as employee loyalty.

### *Two Problem Benefits - Automobiles and Loans*

3-73. Before leaving this general discussion of tax planning considerations related to employee benefits, we would note that two important types of benefits present significant difficulties with respect to determining their desirability. These two benefits are employer provided automobiles and loans to employees.

3-74. The basic problem in both cases is that the benefit to the employee is not based on the cost to the employer. In the case of the employee benefit associated with having the use of an employer supplied car, it is partially based on an arbitrary formula, under which the cumulative assessed benefit can exceed the cost of the car. In the case of employee loans, the taxable benefit is assessed using the prescribed rate of interest, not the cost of the funds to the employer.

3-75. Because of this lack of reciprocity in the measurement of the cost and benefit, a case-by-case analysis is required. In each situation, it must be determined whether the cost to the employer is greater than, or less than, the benefit to the employee. If the cost is greater, the employer may wish to consider some alternative, and more tax effective, form of compensation. This makes these benefits considerably more difficult to administer.

3-76. The taxable benefits associated with both employer provided automobiles and employer provided loans are discussed in detail at a later point in this chapter.

**Exercise Three - 4**

**Subject:** Planning Employee Benefits

As part of her compensation package, Jill Tyler is offered the choice of: a dental plan for her family, an annual vacation trip for her family, or an annual birthday gift of season's tickets to the ballet for her and her spouse. The alternative benefits are each worth about $4,000 per year. Indicate which benefit would be best for Jill from a tax point of view and explain your conclusion.

**SOLUTION available in print and online Study Guide.**

## Inclusions - GST/HST/PST On Taxable Benefits

3-77. Many benefits included in employment income are goods and services on which an employee would have to pay GST, HST, or PST if he personally acquired the item or service. For example, if an employer provides a free domestic airline ticket to reward an Ontario employee for outstanding service, this is an item on which the employee would have to pay 13 percent HST if he purchased the ticket on his own. This means that the taxable benefit should also include an HST component as the employee has received a benefit with a real value that includes both the price of the ticket and the related HST.

3-78. Given this situation, ITA 6(7) requires the calculation of employee benefits on a basis that includes any GST/HST/PST that was paid by the employer on goods or services that are included in the benefit. In situations where the employer is exempt from these taxes, a notional amount is added to the benefit on the basis of the amounts that would have been paid had the employer not been exempt.

**Exercise Three - 5**

**Subject:** GST On Taxable Benefits

Ms. Vicki Correli, as the result of an outstanding sales achievement within her organization, is awarded a two week vacation in the Bahamas. Her Alberta employer pays a travel agent $4,500, plus GST of $225 for the trip. What is the amount of Ms. Correli's taxable benefit?

**SOLUTION available in print and online Study Guide.**

# Inclusions - Automobile Benefits

## Employees And Automobiles

### *Influence On Employment Income*

3-79. Automobiles have an influence on the determination of an individual's employment income in three different situations. These situations can be described as follows:

**Employer Provided Automobiles** It is fairly common for a business to provide an automobile to an employee in order to assist the individual in carrying out his employment duties. In most cases, the employee will be able to make some personal use of the vehicle that is provided. If this is the case, the employee will have a taxable benefit which must be added to his employment income.

**Allowances** As an alternative to providing an employee with an automobile, some employers pay an allowance to the employee for employment related use of his personally owned automobile. This allowance may be included in employment income and, when this is the case, the employee will be able to deduct some portion of the automobile's costs against such inclusions.

**Deductible Travel Costs** Under certain circumstances, employees can deduct various travel costs. If the employee uses his personally owned automobile for travel related to his employment, a portion of the costs associated with this vehicle can be deducted in the determination of employment income.

3-80. In this Chapter, we will give detailed attention to the benefit resulting from employer provided automobiles, as well as to the appropriate treatment of allowances for automobile costs. With respect to automobile related travel costs, the rules for these deductions are the same for both employees and businesses. Because of this, we will defer some of our coverage of this subject to Chapter 6 which deals with business income.

### *Tax Benefit - Employer Provided Automobile*

3-81. There are two types of costs that can be associated with ownership of an automobile. First, there is a fixed cost that accrues from simply owning the vehicle over time. As you are all aware, if you own a car, its value will decline, even if you do not drive the vehicle a single kilometer. For an average vehicle, this "depreciation" takes place on something close to a 25 percent declining balance basis.

3-82. In addition to this fixed cost or annual depreciation, there will be costs associated with operating the vehicle. These costs will tend to have a direct relationship to the number of kilometers driven. However, the per kilometer amount will vary significantly, depending on the type and age of the vehicle that is being driven.

3-83. Tax legislation reflects this economic analysis. The two benefits that can be assessed to an employee who is provided with an employer owned or leased automobile can be described as follows:

**Standby Charge** This benefit is assessed under ITA 6(1)(e). This benefit reflects the fixed cost of owning an automobile. However, we will find that the amount assessed can vary with the amount of personal, non-employment usage of the vehicle.

**Operating Cost Benefit** This benefit is assessed under ITA 6(1)(k) and, as the name implies, it reflects the costs of operating the vehicle. You should note, however, that it is not based on the employer's actual costs. It is assessed at a fixed rate for each kilometer that the employee drives for personal or non-employment usage.

3-84. As discussed in Paragraph 3-77, a GST/HST/PST component must be included when taxable benefits provided to employees involve goods or services that would normally be subject to the GST, PST, or HST. Personal use of an automobile falls into this category. Both the standby charge benefit and the operating cost benefit that are discussed in the following material are calculated in a manner that includes a GST/HST/PST component.

### Allowances And Deductible Travel Costs

3-85. Both allowances and deductible travel costs involve the determination of amounts that can be deducted by an employee who owns or leases his own automobile. As you may be aware, tax legislation places limits on the amounts that can be deducted for automobile costs, e.g., for 2019, lease payments in excess of $800 per month before taxes are not deductible. In addition, tax depreciation (capital cost allowance or CCA) cannot be deducted on automobile costs in excess of $30,000 before taxes. As these limits are the same for an employee who owns or leases a vehicle that is used in employment activities, and for a business that owns or leases a vehicle that is used in business activities, they are given detailed coverage in Chapter 6 on business income, after we have covered CCA in Chapter 5.

3-86. However, it is important to note here that the limits that are placed on the deductibility of automobile costs have no influence on the amount of the taxable benefit that will be assessed to an employee who is provided with a vehicle by his employer. The taxable benefit to the employee will be the same, without regard to whether the employer can deduct the full costs of owning or leasing the vehicle. This means that if an employer provides an employee with an automobile that costs $150,000, the employee's benefits will be based on the full $150,000, despite the fact that the employer will be able to deduct capital cost allowance on only $30,000.

## Taxable Benefits - Standby Charge

### Employer Owned Vehicles

3-87. While ITA 6(1)(e) requires the inclusion of a standby charge in income, ITA 6(2) provides the formulas for calculating this amount. If the employer owns the automobile, the basic standby charge is determined by the following formula:

**[(2%)(Cost Of Car)(Periods Of Availability)]**

3-88. The components of this formula require some additional explanation:

**Cost Of Car** The cost of the car is the amount paid, without regard to the list price of the car. It includes all related GST/PST/HST amounts.

**Periods Of Availability** Periods of availability is roughly equal to months of availability. However, it is determined by dividing the number of days the automobile is "made available" by 30 and rounding to the nearest whole number. Oddly, a ".5" amount is rounded down rather than up.

**Made Available** One would think that if an employee simply returned the automobile and its keys to an employer's premises it would not be considered "available for use". For example, if an employee was traveling out of the country for 2 months, you might assume that, if he left the vehicle and keys with his employer during this period, it would not be considered available for his use. However, this is not the case. In a 2011 Income Tax Ruling (#040922), the CRA has indicated that the employee must be "required" to return the vehicle to the employer's premises to avoid the accrual of a

taxable benefit. This means that it is not sufficient to voluntarily return the vehicle. It must be the policy of the employer to require this return.

3-89. If we assume that a vehicle was available throughout the year and cost $33,900, including $3,900 in HST, the standby charge would be $8,136 [(2%)($33,900)(12)]. If the vehicle continues to be available to the employee throughout the year for subsequent years, the benefit would be the same each year, without regard to the age of the car.

3-90. You should note that the application of this formula can result in a situation where the cumulative standby charge will exceed the cost of the automobile.

**EXAMPLE** An employee has use of an automobile that cost $56,500, including HST. This availability continues for five years (60 months).

**ANALYSIS** The taxable benefit resulting from the standby charge calculation would be $67,800 [(2%)($56,500)(60)]. This taxable benefit is 20 percent larger than the cost of the car to the employer.

## *Employer Leased Vehicles*

3-91. In those cases where the employer leases the automobile, the basic standby charge is determined by the following formula:

**[(2/3)(Lease Payments For The Year Excluding Insurance)(Availability Factor)]**

3-92. As was the case with the formula for employer owned vehicles, the components of this formula require additional explanation:

**Lease Payments** The amount to be included here is the total lease payments for the year, including any relevant GST/PST/HST. This total would be reduced by any amounts that have been included for insuring the vehicle. The insurance costs are excluded as the CRA considers them to be part of the operating cost benefit.

**Availability Factor** This is a fraction in which the numerator is the number of days during the year the vehicle is available to the employee and the denominator is the number of days during the year for which lease payments were made. If the employee had the use of the vehicle throughout the lease period, the value of this fraction would be 1. When the car is owned by the employer, the *Act* clearly requires the availability period to be based on the days of availability, rounded to the nearest number of 30 day periods. In contrast, when the car is leased, a strict reading of the *Act* requires the availability period to be based on the days available as a fraction of the days in the lease period. However, the *Employers' Guide: Taxable Benefits And Allowances* (T4130), uses the 30 day rounding rule for both purchase and lease situations. We will be using this latter approach in our examples and problems.

3-93. An example will illustrate these procedures:

**EXAMPLE** A vehicle is leased for 3 months at a rate of $750 per month, including HST. The $750 includes a monthly insurance payment of $75 per month. An employee has use of the vehicle for 85 of the 92 days in the lease term.

**ANALYSIS** Since both (85 ÷ 30) and (92 ÷ 30) would round to 3, the standby charge would be $1,350 [(2/3)(3)($750 - $75)(3 ÷ 3)]. If the calculation in the *Act* was strictly followed, the benefit would be $1,247 [(2/3)(3)($750 - $75)(85 ÷ 92)].

3-94. Unlike the situation with an employer owned vehicle, it is unlikely that the taxable benefit associated with a leased vehicle will exceed the value of the automobile. While we have seen no comprehensive analysis to support this view, it seems clear to us that, in most normal leasing situations, the taxable benefit on a leased vehicle will be significantly less than would be the case if the employer purchased the same vehicle.

**EXAMPLE** In the real world, a $55,000 (HST inclusive) vehicle could be leased for 48 months with a lease payment of $800 per month (HST inclusive).

**ANALYSIS - Vehicle Purchased** If the car is purchased, the standby charge will be $13,200 per year [(2%)($55,000)(12)].

**ANALYSIS - Vehicle Leased** If the vehicle is leased, the standby charge will be $6,400 per year [(2/3)(12)($800)(12 ÷ 12)].

3-95. This example illustrates what we believe to be a fairly general result. For a given automobile, the taxable benefit for the employee will be lower in situations where the employer leases the vehicle, rather than purchasing the vehicle. It is our opinion that the only exceptions to this would occur when the lease has a very short term.

### Reduced Standby Charge

3-96. When an employer provides an automobile to an employee, it is usually used by that employee for a combination of personal activities and employment related activities. Among different employees, there are significant variations in the mix of these activities. Employees of some organizations may use the car almost exclusively in carrying out employment related activities. In other situations, particularly when the employer and the employee are not at arm's length (e.g., the employee is related to the owner of the business), the car may be used almost exclusively for personal travel.

3-97. This would suggest that there should be some modification of the basic standby charge in situations where there is only limited personal use of the automobile. This, in fact, is the case. The ITA 6(2) standby charge formula provides for a reduction based on the amount of personal usage of the vehicle.

3-98. The reduction involves multiplying the regular standby charge for either an employer owned or an employer leased vehicle by the following fraction:

$$\frac{\textbf{Non - Employment Kilometres (Cannot Exceed Denominator)}}{\textbf{1,667 Kilometres Per Month Of Availability *}}$$

*The number of months of availability is calculated by dividing the number of days that the automobile is available by 30, and rounding to the nearest whole number.

3-99. In applying this formula, the numerator is based on the number of kilometers driven for personal or non-employment activities. To prevent the fraction from having a value in excess of one, the numerator is limited to the value in the denominator. The denominator is based on the idea that, if the employee uses the automobile for as much as 1,667 kilometers of personal activities in a month (20,004 kilometers per year), the vehicle has fully replaced the need for a personally owned vehicle.

3-100. This fraction can be used to reduce the basic standby charge provided two conditions are met:

- The employee is required by the employer to use the automobile in his employment duties.
- The use of the automobile is "primarily" employment related. In general, "primarily" is interpreted by the CRA to mean more than 50 percent. Note that this standby charge reduction formula is not completely fair to everyone, in that it fails to distinguish between an employee who uses the employer's automobile 49 percent for employment related activity from an employee who uses the automobile exclusively for personal travel. Despite the significant difference in personal usage, they would each be assessed the same standby charge on a given vehicle.

3-101. While the fraction is still applicable when personal use is more than 1,667 kilometers per month (20,004 kilometers for the year), it will be equal to 1 (20,004 ÷ 20,004) and will not provide for any reduction in the basic standby charge.

## Operating Cost Benefit

### Basic Calculation

3-102. In those cases where the employer pays the operating costs for an automobile that is available to an employee, that employee is clearly receiving a benefit related to the portion of these costs that are associated with his personal use of the automobile. An obvious approach to assessing an operating cost benefit would be to simply pro rate operating costs paid by the employer between personal and employment related usage. The problem with this, however, is that the employer would be required to keep detailed cost and mileage records for each employee. This approach is further complicated by the fact that some operating costs incur GST or HST (e.g., gas), while other operating costs are exempt from GST or HST (e.g., car insurance and car licenses).

3-103. Given these problems, ITA 6(1)(k) has provided an administratively simple solution. The operating cost benefit is determined by multiplying a prescribed amount by the number of personal kilometers driven. For 2019, this prescribed amount is $0.28. This amount includes a notional GST or HST component and, as a consequence, no further GST or HST benefit has to be added to this amount.

3-104. Note that this amount is applicable without regard to the level of the actual operating costs, resulting in favourable treatment for employees driving cars with high operating costs and unfavourable treatment for employees using vehicles with low operating costs.

### Alternative Calculation

3-105. There is an alternative calculation of the operating cost benefit. Employees who use an employer provided automobile "primarily" (i.e., more than 50 percent) for employment related activities can elect to have the operating cost benefit calculated as one-half of the standby charge by notifying their employer. This alternative calculation does not have to be used and, in many situations, it will not be a desirable alternative as it will produce a higher figure for the operating cost benefit.

### Parking

3-106. It should be noted that ITA 6(1.1) specifically excludes any benefit related to employer provided parking from the automobile operating cost benefit. This does not mean that employer provided parking is not a taxable benefit. While parking is not considered to be a component of the automobile benefit calculation, the Employers' Guide makes it clear that, in general, it is a taxable benefit. The logic of this is that parking may be provided to employees who are not provided with an automobile and, as a consequence, it should be accounted for separately from the automobile benefit calculation.

3-107. As noted in Paragraph 3-63, there are exceptions to the requirement to record parking as a taxable benefit. Parking is not considered to be a taxable benefit in the following situations:

- Parking for employees with disabilities.
- Parking for employees who regularly require a car to carry out their employment duties.
- Scramble parking.

## Payments By Employee For Automobile Use

3-108. Under ITA 6(1)(e), the standby charge benefit can be reduced by payments made by the employee to the employer for the personal use of the automobile. In corresponding fashion under ITA 6(1)(k), the operating cost benefit can also be reduced by such payments.

3-109. Note, however, that if the employee pays part of the operating costs (e.g., the employee personally pays for gas), it does not reduce the basic $0.28 per kilometer benefit. This is not a desirable result and, if the employee is going to be required to pay a portion of the operating expenses, the employer should pay for all of the costs and have the employee reimburse the employer for the appropriate portion. Under this approach, the payments will reduce the operating cost benefit.

**Figure 3 - 2 Summary Of Automobile Benefit Calculations**

The **full** standby charge calculation on an employer owned or leased vehicle is:

**Owned** [(2%)(Cost Of Car*)(Days Available ÷ 30 Rounded)]

**Leased** $\left[\left(\frac{2}{3}\right)\left(\begin{matrix}\text{Lease Payments}\\ \text{For The Year *}\end{matrix}\right)\left(\frac{\text{Days Available} \div 30 \text{ Rounded}}{\text{Days Leased} \div 30 \text{ Rounded}}\right)\right]$

* Including GST/HST/PST, but excluding any insurance in lease payment

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A **reduced** standby charge is available if employment related usage is greater than 50%. The calculation is as follows:

$$\left[\left(\begin{matrix}\text{Full Standby}\\ \text{Charge}\end{matrix}\right)\left(\frac{\text{Personal Use Kilometres (Cannot Exceed Denominator)}}{\text{1,667 Kilometres Per Month Of Availability}}\right)\right]$$

---

The **regular** operating cost benefit for 2019 is $0.28 per personal use kilometer.

An **alternative** operating cost benefit calculation is available if employment related usage is greater than 50%. It is [(1/2)(Standby Charge, reduced if applicable)].

## Summary Of Automobile Benefit Calculations

3-110. Figure 3-2 summarizes the calculations that relate to the taxable benefit arising from employer provided automobiles.

## Example - Employer Owned Automobile

3-111. The following data will be used to illustrate the calculation of the taxable benefit where an employee is provided with a vehicle owned by an employer in 2019.

| | |
|---|---|
| Cost Of The Automobile ($30,000 + $3,900 HST) | $33,900 |
| Days Available For Use | 310 |
| Months Owned By The Employer | 12 |
| Total Kilometers Driven | 30,000 |
| Personal Kilometers Driven | 16,000 |

3-112. The 310 days of availability would be rounded to 10 months (310 ÷ 30 rounded). The basic standby charge benefit to be included in employment income would be calculated as follows:

**Standby Charge** = [(2%)($33,900)(10)] = $6,780

3-113. As less than 50 percent [(30,000 - 16,000) ÷ 30,000 = 46.7%] of the driving was related to the employer's business, no reduction in the basic standby charge is available. Also note that the cost figure used in the preceding calculation includes the HST.

3-114. The operating cost benefit to be included in employment income is as follows:

**Operating Cost Benefit** = [($0.28)(16,000)] = $4,480

3-115. As the employment related use of the car was less than 50 percent, there is no alternative calculation of the operating cost benefit.

3-116. As the employee does not make any payments to the employer for the personal use of the automobile, the total taxable benefit included in employment income is as follows:

**Total Taxable Benefit** = ($6,780 + $4,480) = $11,260

## Exercise Three - 6

**Subject:** Taxable Benefits - Employer Owned Automobile

Mrs. Tanya Lee is provided with an automobile by her employer. The employer acquired the automobile in 2018 for $25,000, plus $1,250 GST and $2,000 PST. During 2019, Ms. Lee drives the automobile a total of 28,000 kilometers, 16,000 of which were related to employment duties. The automobile is available to Mrs. Lee throughout the year. Calculate Mrs. Lee's minimum 2019 taxable benefit for the use of the automobile.

**SOLUTION available in print and online Study Guide.**

## Example - Employer Leased Vehicle

3-117. To provide a direct comparison between the employer owned and employer leased cases, this example will be based on the same general facts that were used in the ownership example. If the employer was to lease a $30,000 car with a 36 month lease term, the lease payment, calculated using normal lease terms, would be approximately $822 per month, including HST (this $822 value cannot be calculated with the information given). With the exception of the fact that the car is leased rather than purchased by the employer, all of the other facts are the same as in the Paragraph 3-111 example. The standby charge benefit would be calculated as follows:

**Standby Charge** = [(2/3)($822)(10*)] = $5,480

* The availability factor of 10 is calculated as (310 ÷ 30 rounded).

**A Note On Calculations** The ITA 6(2) formula (as described in Figure 3-2) requires the total lease payments made for the year be multiplied by a ratio that has months available divided by the months leased. As lease payments are generally given on a monthly basis, the literal use of this formula would result in the following calculation:

**Standby Charge (ITA Calculation)** = [(2/3)(12)($822)(10/12*)] = $5,480

* The availability factor is calculated as [(310 ÷ 30 rounded)/(365 ÷ 30 rounded)].

Many of our users were previously confused by the fact we first multiplied by the 12 months in the lease period and then divided by the same 12 months. As they pointed out, this double calculation is not relevant to the final result. Given this, in our calculations and problem material, we use the simpler calculation shown in the first equation in which the factor of 2/3 is multiplied by the total lease payments for the period of availability. *Income Tax Act* purists are likely to be offended. However, our focus is on helping users understand the difficult material that is found throughout this text.

3-118. As was the case when the car was owned by the employer, there is no reduction for actual employment related kilometers driven because the car was driven less than 50 percent for employment related purposes. Also note that the benefit is based on the lease payment including HST.

3-119. The operating cost benefit is the same as the employer owned case and is as follows:

**Operating Cost Benefit** = [($0.28)(16,000)] = $4,480

3-120. As in the case where the employer owned the car, with the employment related use of the car at less than 50 percent, there is no alternative calculation of the operating cost benefit.

3-121. Since the employee does not make any payments to the employer for the personal use of the automobile, the total taxable benefit is as follows:

**Total Taxable Benefit** = ($5,480 + $4,480) = $9,960

3-122. Note that the total benefit is significantly less ($9,960 as compared with $11,260) when the employer leases the car as opposed to purchasing it. As indicated in our earlier discussion in Paragraph 3-95, this would be the anticipated result.

## Exercise Three - 7

**Subject:** Taxable Benefits - Employer Leased Automobile

Mr. Michael Forthwith is provided with a car that is leased by his employer. The monthly lease payments for 2019 are $525, plus $68 HST. During 2019, he drives the automobile a total of 40,000 kilometers, of which 37,000 kilometers are employment related. The automobile is used by him for 325 days during the year. His employer paid a total of $11,250 in operating costs. When he is not using the automobile, company policy requires that it be returned to their premises. Calculate Mr. Forthwith's minimum 2019 taxable benefit for the use of the automobile.

**SOLUTION available in print and online Study Guide.**

## Employer Provided Cars And Tax Planning

3-123. Providing employees with cars is not a clearly desirable course of action. As is discussed in more detail in Chapter 6, there are limits on the ability of the employer to deduct the costs of owning or leasing the vehicle (e.g., leasing costs in excess of $800 per month before taxes are not deductible). Further, the taxable benefit calculations are such that they may produce a taxable benefit that exceeds the value to the employee of having the car.

3-124. This means that a decision by an employer to provide an employee with a car requires a careful analysis of all of the relevant factors. While a complete analysis of all of these issues goes beyond the scope of this material on employment income, some general tax planning points can be made.

**Require The Car Be Returned** In many situations, there will be periods of time when an employee does not use an employer provided vehicle. Examples would include vacation periods, extensive periods of travel for work, or confinement because of illness. During such periods, the vehicle will be considered available for use unless the employer requires it to be returned to their premises. Given this, the employer should have a policy of requiring vehicles to be returned during periods of non-use by the employee.

**Record Keeping** In the absence of detailed records, an employee can be charged with the full standby charge and 100 percent personal usage. To avoid this, it is essential that records be kept of both employment related and personal kilometers driven.

**Leasing Vs. Buying** As was previously noted, in most cases, a lower taxable benefit will result when the employer leases the car rather than purchases it. One adverse aspect of leasing arrangements should be noted. Lease payments are made up of a combination of both interest and principal payments on the car. As the taxable benefit is based on the total lease payment, the interest portion becomes, in effect, a part of the taxable benefit.

**Minimizing The Standby Charge** This can be accomplished in a variety of ways including longer lease terms, lower trade-in values for old vehicles in purchase situations, larger deposits on leases, and the use of higher residual values in leasing arrangements. However, this minimization process is not without limits. As is explained in Chapter 6, refundable deposits in excess of $1,000 on leases can reduce the deductible portion of lease costs.

**Cars Costing More Than $30,000** With the taxable benefit to the employee based on the full cost of the car and any portion of the cost in excess of $30,000 not being deductible to the employer (this limit on the deductibility of automobile expenses is discussed in Chapter 6), it is difficult to imagine situations in which it would make economic sense for a profit oriented employer to provide any employee with a luxury car. As the taxable benefit to the employee is based on the actual cost of the car, while the deductible amount is limited to $30,000, a situation is created in which the employee is paying taxes on an amount which can be significantly larger than the amount that is deductible to the employer. For example, the standby charge on a $150,000 Mercedes-Benz is $36,000 per year [(2%)($150,000)(12)], an amount that may be fully taxable to the employee. In contrast, the employer's deduction for capital cost allowance (tax depreciation) in the first year of ownership is limited to only $4,500 [($30,000)(30%)(1/2)]. The winner in this type of situation is the CRA.

**Consider The Alternative** The alternative to the employer provided automobile is to have the employer compensate the employee for using his own automobile. In many cases this may be preferable to providing an automobile. For example, in those situations where employment related use is less than 50 percent, the provision of an automobile to an employee will result in a benefit assessment for the full standby charge. If employment related use was 45 percent, for example, it is almost certain that the amount assessed will exceed the actual benefit associated with 55 percent personal use of the vehicle. If, alternatively, the employee is reasonably compensated for using his own personal vehicle, there is no taxable benefit.

**We suggest you work Self Study Problems Three-3, 4 and 5 at this point.**

# Inclusions - Allowances

## Allowance Vs. Reimbursement

3-125. A reimbursement is an amount paid to an employee to compensate that individual for amounts that he has disbursed in carrying out his employment duties. An example would be an employee who purchases an airline ticket for travel on behalf of his employer. The employee will present the receipt to the employer who reimburses the employee for the amount shown on the receipt. In general, such reimbursements have no tax consequences for the employee. As noted in Paragraph 3-63, an exception to this is when an employer reimburses an employee for tools used in his work. Reflecting the fact that employees cannot, in general, deduct the cost of their tools, this reimbursement must be treated as a taxable benefit.

3-126. The situation is more complex with allowances. These are amounts that are paid, usually to provide a general level of compensation, for costs that an employee incurs as part of his employment activities. However, as there is no direct, dollar-for-dollar relationship with the actual costs incurred, the tax treatment of these items is more complicated. These complexities are dealt with in the material that follows.

## General Rules

3-127. The term allowance is used to refer to amounts received by employees from an employer other than salaries, wages, benefits, and reimbursements. In practice, allowances generally involve payments to employees as compensation for travel costs, use of their own automobile, or other costs that have been incurred by employees as part of their efforts on behalf of the employer. A mileage allowance for a traveling salesperson or a technician who does service calls would be typical examples of such an allowance.

3-128. ITA 6(1)(b) provides a general rule which requires that allowances for personal or living expenses must be included in an employee's income. However, many of the items for which employees receive allowances are costs that an employee can deduct against

employment income under ITA 8. (See the discussion of deductions later in this Chapter for a full explanation of these amounts.) Examples of such deductible items are as follows:

- ITA 8(1)(f) salesperson's expenses
- ITA 8(1)(h) traveling expenses other than motor vehicle expenses
- ITA 8(1)(h.1) motor vehicle traveling expenses
- ITA 8(1)(i) professional dues, office rent, salaries, and supply costs
- ITA 8(1)(j) motor vehicle capital costs (interest and capital cost allowance)

3-129. If allowances for these items are included in the employee's income, a circular process is involved in which they are added under ITA 6(1)(b) and then subtracted under ITA 8. In view of this, ITA 6(1)(b) indicates that there are exceptions to the rule that allowances must be included in income. While there is a fairly long list of such items, the most important of these exceptions involve allowances paid for the types of costs that would be deductible under ITA 8. Specifically, the following allowances are among those that do not have to be included in an employee's income:

- ITA 6(1)(b)(v) - Reasonable allowances for traveling expenses paid during a period in which the employee was a salesperson (includes allowances for the use of a motor vehicle).
- ITA 6(1)(b)(vii) - Reasonable allowances for traveling expenses for employees other than salespersons, not including allowances for the use of a motor vehicle.
- ITA 6(1)(b)(vii.1) - Reasonable allowances for the use of a motor vehicle for employees other than salespersons.

## Taxable Vs. Non-Taxable Allowances

3-130. The preceding general rules mean that there are two possible treatments of allowances paid to employees for travel and motor vehicle costs.

**Non-Taxable Allowances** If a reasonable allowance is paid to an employee, it will not be included in the employee's income records (T4 Information Return). However, when such allowances are not included in income, the employee will not be able to deduct his actual costs. For example, if an individual received $150 per day of travel to cover hotel costs, this would probably be considered reasonable and not included in his income. If the employee chose to stay at a luxury hotel for $400 per day, he would not be able to deduct the additional cost associated with this choice. Alternatively, if he chose to stay at a hostel for $50 per day, he would pocket the excess allowance on a tax free basis.

**Taxable Allowances** If an allowance is not considered to be reasonable, it will be included in the employee's T4 Information Return for the period. To the extent the employee can qualify for the deduction of employment related travel or commission salespersons expenses, related expenses incurred by the employee can be deducted in the determination of his net employment income. If the employee's actual costs exceed the allowance, having the allowance included in his income will be advantageous. Conversely, if his actual costs are less than the allowance, the result will be a net inclusion in employment income.

3-131. It is not clear what constitutes a reasonable amount in the case of the general costs of travel. It appears that, as long as an allowance appears to be in line with actual costs for food, lodging, and miscellaneous costs, the allowance that is provided is likely to be viewed as reasonable.

3-132. However, if a junior employee was given $30,000 a month for food and lodging and he was known to be staying at budget motels and eating fast food, it is likely that the allowance would have to be included in income and reduced, to the extent possible, by actual costs incurred (while this example sounds unrealistic, it might be attempted in an owner-managed business where the employee was not dealing at arm's length with the employer).

3-133. Although it may be more difficult to administer and more costly for the employer, reimbursement of actual costs is less likely to cause this type of tax problem for employees than providing an arbitrarily determined general allowance to cover all possible costs.

## Reasonable Allowances For Motor Vehicles

3-134. In Paragraph 3-129, we noted that ITA 6(1)(b)(v) and 6(1)(b)(vii.1) indicate that "reasonable allowances" for an employee's use of a motor vehicle do not have to be included in the employee's income. While the *Act* is not specific as to what constitutes a reasonable allowance for the use of a motor vehicle, it does point out that an allowance will be deemed not to be reasonable:

- if it is not based solely on the number of kilometers for which the vehicle is used in employment duties [ITA 6(1)(b)(x)]; or
- if the employee, in addition to the allowance, is reimbursed for all or part of the expenses of using the vehicle [(ITA 6(1)(b)(xi)].

3-135. With respect to the first of these conditions, it is clear that an allowance of $200 per month would have to be included in the employee's income. Any allowance that is not specifically based on kilometers is deemed to be unreasonable. This, however, does not answer the question as to what constitutes a reasonable allowance.

3-136. On the upper end, the CRA has indicated that if a per kilometer allowance exceeds the prescribed amount that is deductible for a business, it will be considered unreasonable, resulting in its inclusion in the employee's income. For 2019, the relevant amounts are $0.58 per kilometer for the first 5,000 kilometers driven by a given employee, and $0.52 for each additional kilometer.

3-137. While it is clear that an allowance that is not based on kilometers would be viewed as unreasonable by the CRA, the possibility remains that an allowance could be considered unreasonable based on its size. There has been one case (Brunet vs. H.M.Q) in which an employee was allowed to include a $0.15 per kilometer allowance and deduct actual cost. However, it is unlikely that very many employees would wish to purse this approach.

### Exercise Three - 8

**Subject:** Deductible Automobile Costs

Ms. Lauren Giacomo is required by her employer to use her own automobile in her work. To compensate her, she is paid an annual allowance of $3,600. During the current year, she drove her automobile a total of 24,000 kilometers, of which 6,500 kilometers were employment related. Her total automobile costs for the year, including lease costs, are $7,150. What amounts should Ms. Giacomo include and deduct in determining net employment income for the current year?

### Exercise Three - 9

**Subject:** Automobile Allowances

During the current year, Jacob Lorenz leases an automobile for $450 per month, a total for the year of $5,400. He drives a total of 60,000 kilometers, of which 35,000 are employment related. His total operating costs for the year are $15,000. His employer pays him $0.10 for each employment related kilometer driven, a total of $3,500. What amounts should Mr. Lorenz include and deduct in determining net employment income for the current year?

**SOLUTIONS available in print and online Study Guide.**

## Employer's Perspective Of Allowances

3-138. From the point of view of the employer, paying taxable allowances is the easiest solution. All amounts paid will be included in the income of the employees and, as a consequence, there is no necessity for the employer to maintain detailed records of actual costs. It is up to the employee to keep these records and to claim the relevant deductible costs against the allowances included in their T4 Information Return.

3-139. Somewhat more onerous is an approach which uses direct reimbursements of the employee's actual costs. Some efficiencies are available here in that the CRA will generally accept a modest per diem for food without requiring detailed documentation from either the employer or the employee. However, for more substantial costs, the reimbursement approach involves more detailed record keeping than is the case with the use of taxable allowances.

3-140. In the case of employee owned automobile costs, the use of non-taxable allowances is particularly complex. As we have noted, the 2019 amounts that can be deducted by an employer for automobile costs are generally limited to $0.58 per kilometer for the first 5,000 kilometers driven by a given employee, and $0.52 for each additional kilometer. If a non-taxable allowance is based on these rates, the employer will have to keep detailed employee-by-employee mileage records to support the deduction of automobile costs.

## Employee's Perspective Of Allowances

3-141. From the employee's point of view, the receipt of a non-taxable allowance represents a very simple solution to the problem. While records may have to be kept for the information needs of the employer, the employee has the advantage of simply ignoring the allowance and the related costs when it comes time to file a tax return.

3-142. In real economic terms, however, the non-taxable allowance approach may or may not be advantageous. If the employee's actual deductible costs exceed the allowance, the non-inclusion of the allowance in income eliminates the deductibility of the additional costs. Alternatively, if the actual costs are less than the allowance, the employee has, in effect, received a tax free benefit.

### Exercise Three - 10

**Subject:** Travel Allowances

Sandra Ohm travels extensively for her employer. Her employer provides an allowance of $200 per day to cover hotel costs. In addition, she is paid $0.41 per kilometer when she is required to use her automobile for travel. For her work, during the current year, she traveled a total of 82 days and drove 9,400 kilometers.

Her employer paid her $16,400 for lodging [(82)($200)], as well as $3,854 dollars for mileage [(9,400)($0.41)]. Her actual lodging costs were $18,300, while her total automobile costs were $7,200, including monthly lease payments. Her total mileage on the car during the year was 23,500 kilometers.

What amounts should Ms. Ohm include and deduct in determining net employment income for the current year?

**SOLUTION available in print and online Study Guide.**

# Inclusions - Employee Insurance Benefits

## Life Insurance

3-143. The cost of providing life insurance benefits to employees is a taxable benefit under ITA 6(4). This means that any premiums paid on a life insurance policy by the employer must be included in employment income. In the event of the employee's death, the benefit payment received by his estate would not be taxable. No GST (or HST) amount would be included in this benefit as insurance services are exempt from GST (see Chapter 21).

## Disability Insurance (a.k.a. Group Sickness Or Accident Insurance Plans)

3-144. The basic rules for group disability insurance plans are as follows:

**Contributions By Employee** Contributions made by an employee are not deductible by the employee against employment income. However, they can be offset against taxable disability benefits received.

**Contributions By Employer** Employer contributions do not create a taxable benefit to the employee as long as the plan benefits received by an employee are taxable. Under ITA 6(1)(f), benefits are taxable to an employee provided they are (1) paid on a periodic basis, and (2) paid to compensate the individual for loss of employment income. If plan benefits do not meet both of these criteria (such as benefits for accidental death), they are not taxable and the employer contributions will be considered a taxable benefit to the employee.

**Benefits Received (Employer Makes No Contributions)** In the unusual situation where the employee makes all of the contributions to the plan, benefits will be received tax free.

**Benefits Received (Employer Makes Any Part Of The Contributions)** If the employer makes any part of the contributions, the benefits received by an employee will be taxable. However, the employee can offset the income inclusion by the amount of contributions that he has made to the plan prior to receiving the benefits and during the year he received the benefits. If plan benefits are not taxable, the employer's contribution will be treated as a taxable benefit.

3-145. These rules give rise to three possible situations:

**Employee Pay All Plans** If the employee makes 100 percent of the contributions to the plan, the contributions will not be deductible and any benefits received will not be taxed.

**Employer Contributes - Benefits Not Taxed** If the employer makes all or part of the contributions to the plan and benefits received are not taxed (because they are not periodic or do not replace employment income), the employer contributions to the plan will be treated as a taxable benefit to the employee. Any employee contributions to the plan are not deductible.

**Employer Contributes - Benefits Taxed** If the employer makes all or part of the contributions to the plan and benefits received by the employee are taxed, the employer's contributions do not create a taxable benefit. Any employee contributions to the plan are not deductible by the employee. However, the cumulative amount of contributions made prior to receiving benefits and those made during the year the benefits are received can be used to offset the benefits received.

3-146. The most common of these situations is the last one in which the employer makes contributions that do not create a taxable benefit for the employee, with any benefits received being taxed in the hands of the employee. Most of our examples and problems will be based on this type of situation.

3-147. You should note that these rules only apply to group disability plans. If the plan is not a group plan, any contributions made by an employer will be treated as a taxable benefit to the employee.

**EXAMPLE** Jane Forthy's employer sponsors a group disability insurance plan which provides periodic benefits to compensate for lost employment income. During the period January 1 through April 1 of the current year, Jane's contributions to the plan totaled $1,200. On April 1 of the current year she was involved in a car accident which prevented her from working during the remainder of the year. During this period from April 1 through December 31, she received disability benefits of $16,000. In the previous year, the first year she participated in the plan, Jane contributed a total of $3,600 in premiums to this plan.

**ANALYSIS** Jane's income inclusion for the current year would be $11,200 [$16,000 - $1,200 - $3,600].

3-148. As noted in the previous section on life insurance, insurance services are exempt from GST/HST, and no GST/HST amount is associated with taxable benefits related to disability insurance.

## Exercise Three - 11

**Subject**: Disability Insurance Benefits

Mr. Lance Bardwell is a member of a group disability plan sponsored by his employer. The plan provides periodic benefits to compensate for lost employment income. During 2019, his employer's share of the annual premium was $1,800. During 2018, Mr. Bardwell was required to contribute $300 to this plan. During the last 6 weeks of 2019, Mr. Barwell became incapacitated and, as a consequence, received $5,250 in benefits from the disability plan. Because of this period of disability, his 2019 contribution to the disability plan was only $225. What amount will Mr. Bardwell include in his 2019 employment income?

**SOLUTION available in print and online Study Guide.**

# Loans To Employees

## General Rules

3-149. If an employer extends a loan to an employee that is either interest free or has a rate that is below the going market rate, the employee is clearly receiving a benefit that should be taxed. This view is reflected in ITA 6(9), which requires the assessment of a taxable benefit on all interest free or low interest loans to employees. This provision applies whether the loan is made as a consequence of prior, current, or future employment.

3-150. As specified in ITA 80.4(1), which describes how this benefit is calculated, the taxable benefit would equal imputed interest calculated at a rate specified in the *Income Tax Regulations*. This rate, as determined by ITR 4301, is referred to as the prescribed rate (note that this rate was discussed in more detail in Chapter 2). It is established for each calendar quarter on the basis of Government Of Canada Treasury Bill yields. In general, the taxable benefit is calculated using the prescribed rate that is applicable to each calendar quarter. The amount of the benefit is reduced by any interest paid on the loan by the employee during the year or within 30 days of the end of the year.

**EXAMPLE** On January 1 of the current year, Ms. Brooks Arden borrows $50,000 from her employer at an annual rate of 1 percent. Assume that during this year, the prescribed rate is 3 percent during the first two quarters, and 4 percent during the last two quarters. Ms. Arden pays the required 1 percent interest on December 31.

**ANALYSIS** The taxable benefit to be included in Ms. Arden's net employment income would be calculated as follows:

| | |
|---|---|
| Imputed Interest: | |
| Quarters 1 and 2 [(3%)($50,000)(2/4)] | $ 750 |
| Quarters 3 and 4 [(4%)($50,000)(2/4)] | 1,000 |
| Total Imputed Interest | $1,750 |
| Interest Paid [(1%)($50,000)] | ( 500) |
| Taxable Benefit | $1,250 |

In general, interest calculations that are made for tax purposes are based on the number of days the principal is outstanding. However, IT-421R2, in its illustration of employee loan interest calculation, uses calendar quarters and treats each calendar quarter as one-quarter of the year. In situations where full calendar quarters are involved we will use this approach in our text and problem material.

3-151. Several additional points should be made with respect to these loans:

- If the rate negotiated with the employer is at least equal to (or greater than) the rate that the employee could have negotiated himself with a commercial lender, then under ITA 80.4(3), no benefit will be assessed to the employee regardless of subsequent changes to the prescribed rate. However, this is rarely applicable as the prescribed rate is consistently lower than rates available on loans to individuals from commercial lenders.

- ITA 80.4(2) contains a different set of rules that is applicable to loans made to certain shareholders of a company. The different rules that are applicable to shareholders are described in Chapter 15, "Corporate Taxation And Management Decisions".

- Proceeds from a loan to an employee could be used to invest in assets that produce business or property income. In general, interest paid on loans to finance investments is deductible against the income produced. ITA 80.5 clearly states that an imputed interest benefit assessed under ITA 80.4(1) or 80.4(2) is deemed to be interest paid for the purposes of determining net business or property income. Referring to the example in Paragraph 3-150, if Ms. Arden had invested the $50,000 loan proceeds in income producing assets, her deductible interest would total $1,750, the $500 that she paid, plus the assessed $1,250 taxable benefit.

- When the purpose of the loan is to assist an employee with a home purchase, ITA 80.4(4) indicates that the annual amount of interest used in the benefit calculations cannot exceed the annual amount determined using the prescribed rate in effect when the loan was extended. Note that this rule is applied on an annual basis, not on a quarter by quarter basis.

  This provides a ceiling for the benefit and, at the same time, allows the taxpayer to benefit if the prescribed rate becomes lower. This ceiling on the benefit is only available for the first five years such loans are outstanding. ITA 80.4(6) indicates that, after this period of time, the loan will be deemed to be a new loan, making the calculation of the benefit subject to the prescribed rate in effect at this point in time. This new rate will again serve as a ceiling for the amount of the benefit for the next five years.

  **EXAMPLE** On January 1 of the current year, an employee receives a $200,000, interest free home purchase loan from his employer. Assume that the prescribed rate is 4 percent for the first quarter, 3 percent during the second and third quarters and 7 percent in the fourth quarter.

  **ANALYSIS** If interest is calculated on a quarterly basis, the benefit would be $8,500 [($200,000)(4%)(1/4) + ($200,000)(3%)(2/4) + ($200,000)(7%)(1/4)]. Alternatively, using the prescribed rate in effect at the time the loan was made, the amount is $8,000 [($200,000)(4%)]. As this is lower, the taxable benefit would be $8,000.

## Exercise Three - 12

**Subject:** Housing Loan

On January 1, 2019, Mrs. Caldwell receives a $100,000 loan from her employer to assist her in purchasing a home. The loan requires annual interest at a rate of 1 percent, which she pays on December 31, 2019. Assume that the relevant prescribed rate is 2 percent during the first quarter of 2019, 3 percent during the second quarter, and 1 percent during the remainder of the year. Calculate Mrs. Caldwell's taxable benefit on this loan for the year 2019.

**SOLUTION available in print and online Study Guide.**

# Tax Planning For Interest Free Loans

## General Approach

3-152. Tax rules result in a taxable benefit to the employee if the interest rate on the loan is lower than the prescribed rate. Given this, the question arises as to whether the use of employee loans is a tax effective form of providing employee benefits. As with other types of benefits, the question is whether it is better that the employer supplies the loan or, alternatively, provides sufficient additional salary to allow the employee to acquire the benefit directly. In the case of loans, this additional salary would have to be sufficient to allow the employee to carry a similar loan at commercial rates.

3-153. To determine whether a loan is an effective form of employee compensation, several factors have to be considered:

- the employer's rate of return on alternative uses for the funds
- the employer's tax rate
- the employee's tax rate
- the prescribed rate
- the rate available to the employee on a similar arm's length loan

3-154. In analyzing the use of loans to employees, we begin with the assumption that we would like to provide a requested benefit to one or more employees and we are looking for the most cost effective way of providing the benefit. As noted, the alternative to providing an employee with a loan is to provide that employee with sufficient after tax income to carry an equivalent loan at commercial rates of interest.

3-155. It then becomes a question of comparing the cash flows associated with the employer providing the loan (this would have to include sufficient additional income to pay the taxes on any loan benefit that will be assessed), with the cash flows required for the employer to provide the employee with sufficient income to carry an equivalent loan acquired from a commercial lender.

## Example Of Interest Free Loan Benefit

3-156. The following example illustrates the calculations required to determine whether the use of a low or no interest loan is a tax effective form of employee compensation.

**EXAMPLE** A key executive asks for a $100,000 interest free housing loan. At this time, the employer has an investment opportunity that is expected to provide a rate of return of 12 percent before taxes. Assume the prescribed rate for the period is 2 percent, while the rate for home mortgages is 5 percent. The employee is subject to a marginal tax rate, the tax rate applicable to additional income, of 45 percent, while the employer pays corporate taxes at a marginal rate of 28 percent.

**Alternative 1 - Provide Additional Salary** In the absence of the interest free loan, the employee would borrow $100,000 at 5 percent, requiring an annual interest payment of $5,000. In determining the amount of salary required to carry this loan,

consideration has to be given to the fact that additional salary will be taxed at 45 percent. In terms of the algebra that is involved, we need to solve the following equation for X:

$$\$5,000 = [(X)(1 - 0.45)]$$

You will recall that this type of equation is solved by dividing both sides by (1 - 0.45), resulting in a required salary of $9,091:

$$X = [\$5,000 \div (1 - 0.45)] = \$9,091$$

Using this figure, the employer's after tax cash flow required to provide sufficient additional salary for the employee to carry a conventional $100,000 mortgage would be calculated as follows:

| | |
|---|---|
| Required Salary [$5,000 ÷ (1 - 0.45)] | $9,091 |
| Tax Savings From Deducting Salary [($9,091)(28%)] | ( 2,545) |
| Employer's After Tax Cash Flow - Additional Salary | $6,546 |

**Alternative 2 - Provide The Loan** If the loan is provided, the employee will have a taxable benefit of $2,000 [(2% - Nil)($100,000)], resulting in additional taxes payable of $900 [(45%)($2,000)]. To make this situation comparable to the straight salary alternative, the employer will have to provide the executive with both the loan amount and sufficient additional salary to pay the $900 in taxes on the benefit that will be assessed. The required amount would be $1,636 [$900 ÷ (1 - 0.45)].

The employer's cash flow associated with the after tax cost of providing the additional salary as well as the after tax lost earnings on the $100,000 loan amount would be calculated as follows:

| | |
|---|---|
| Required Salary [$900 ÷ (1 - 0.45)] | $1,636 |
| Tax Savings From Deducting Salary [($1,636)(28%)] | ( 458) |
| After Tax Cost Of Salary To Cover Taxes On Benefit | $1,178 |
| Employer's Lost Earnings [(12%)(1 - 0.28)($100,000)] | 8,640 |
| Employer's After Tax Cash Flow - Loan | $9,818 |

**Conclusion** Given these results, payment of additional salary appears to be the better alternative. However, the preceding simple example is not a complete analysis of the situation. Other factors, such as the employee's ability to borrow at going rates and the employer's ability to grant this salary increase in the context of overall salary policies, would also have to be considered.

## Exercise Three - 13

**Subject:** Loans To Employees - Tax Planning

A key executive asks for a $125,000 interest free housing loan. At this time, the employer has investment opportunities involving a rate of return of 7 percent before taxes. Assume that for the period, the relevant prescribed rate is 2 percent, while the market rate for home mortgages is 5 percent. The employee's tax rate on additional income (i.e., his marginal tax rate), is 42 percent, while the employer's marginal tax rate is 26 percent. Should the employer grant the loan or, alternatively, provide sufficient salary to carry an equivalent loan from a commercial lender? Explain your conclusion.

**SOLUTION available in print and online Study Guide.**

**We suggest you work Self Study Problem Three-6 at this point.**

# Inclusions - Stock Option Benefits

**BYRD/CHEN NOTE** As you are likely aware, stock options are commonly used by corporations to compensate individuals in highly paid executive positions. Despite the fact that these options have a significant value when they are issued, the recipient executives are not required to include any amount in their Net Income For Tax Purposes at that time. Further, when the options are exercised and a value is included in the individual's Net Income For Tax Purposes, a deduction equal to half of the included amount is available in the determination of Taxable Income. In effect, this type of employee compensation is understated when the options are issued and given capital gains treatment on the income that is eventually recognized.

This is clearly not an equitable situation. It is also very significant. The government estimates that, in 2017, individual executives with income in excess of $1,000,000 were allowed stock option deductions equal to $1,340,000,000.

The March 19, 2019 Federal budget proposes to change this situation. In somewhat simplified terms, the proposal will limit the 50 percent deduction to situations where the issue date fair market value of the underlying shares is under $200,000. This new limit would not apply to start-ups and rapidly growing Canadian businesses.

The budget did not include legislation to implement this change, indicating that it would be made available prior to the summer of 2019. Given the major impact of this change, expected opposition from vested interests, and the potential complexity of the required legislation, it is very unlikely that the proposal will be implemented prior to 2020. Given this, we will not provide additional coverage of the proposal in either the text or the related problem material.

## The Economics Of Stock Option Arrangements

3-157. Stock options allow, but do not require, the holder to purchase a specified number of shares for a specified period of time at a specified acquisition price. Because of tax considerations, at the time of granting, the option price is usually at or above the market price of the shares. For example, options might be issued to acquire shares at a price of $10 at a time when the shares are trading at that same $10 value.

3-158. At first glance, such an option would appear to have no value as it simply allows the holder to acquire a share for $10, at a time when that share is only worth that amount. In reality, however, this option could have significant value, in that it allows the holder to participate in any upward price movement in the shares without any obligation to exercise the option if the price stays at, or falls below, $10. Stated alternatively, the option provides full participation in gains on the option shares, with no downside risk. Further, for an employee receiving such options, they provide this participation with no real investment cost until such time as the options are exercised.

**EXAMPLE** Because of his excellent work, Andrew Chang is given options to buy 1,000 shares of his employer's stock at a price of $10 per share. At this time, the shares are trading at $10 per share. One year later, he exercises the options and immediately sells the acquired shares for $12 per share.

**ANALYSIS** Andrew has enjoyed a gain of $2,000 [(1,000)($12 - $10)] with no initial investment. This clearly illustrates why the options have a value, even when they are not issued "in-the-money". The expression "in-the-money" refers to situations where the option price ($10 in this example) is below current market value. In this example, the options are in-the-money when the market value is greater than $10.

3-159. Stock options are granted to employees in the belief that, by giving an employee an interest in the stock of the company, he has an incentive to make a greater effort on behalf of the enterprise. In some companies, use of this form of compensation is restricted to senior

executives. In contrast, other corporations make options available to larger groups of employees.

3-160. At one point in time, a very significant advantage to the use of stock options was that the cost of issuing such options was not recorded in the financial statements of the issuing corporation. Because of an inability of accountants to agree on the appropriate value for options that were not "in-the-money", corporations were able to issue huge quantities of stock options without recording any compensation expense at all.

3-161. However, this is not the current situation. GAAP requires the recognition of a compensation expense when stock options are issued.

3-162. In contrast to the accounting treatment under GAAP, the issuance of stock options has no tax consequences at the time of issue, either for the issuer or the recipient. The issuer cannot deduct any amount to reflect the economic value of the issued options. Further, the recipient does not have any income inclusion when the options are issued.

## Overview Of The Tax Rules

3-163. This is a difficult subject to present in that it involves several different areas of tax legislation. In addition to issues related to employment income, stock options influence the determination of Taxable Income and the calculation of taxable capital gains. While it would be possible to present this material on a piecemeal basis, we have found this to be confusing to our readers. An alternative would be to defer any discussion of this issue until Chapter 8 when all of the relevant material has been covered.

3-164. However, this fails to reflect the fact that stock option issues relate most directly to employment income. As a consequence, most of our material on stock options will be presented in this Chapter. As this involves some material that will not be covered until later Chapters, an overview of the stock option material that will be presented in this Chapter is useful. The basic points here are as follows:

**Value At Issue** As noted previously, the tax rules give no recognition to the fact that stock options have a positive value at the time of issue. The issuing employer can make no deduction and the recipient employee has no income inclusion. As some of you are aware, this is not consistent with accounting procedures in this area. After many years of controversy, accounting procedures were finally modified to recognize some value for stock options when they are issued. The accounting approach better reflects the economic reality associated with these financial instruments.

**Employment Income Inclusion - Measurement** The employment income inclusion will be measured on the date that the options are exercised. The amount will be equal to the excess of the per share fair market value on the exercise date over the option price, with the difference multiplied by the number of shares acquired. This amount will be nil or positive as the employee would not normally exercise the options unless the value of the shares is equal to, or exceeds, the option price.

**Employment Income Inclusion - Recognition** While the employment income inclusion will always be measured at the time the options are exercised, it may not be recognized until the shares are sold. Whether the inclusion will be recognized at the time of exercise or at the time of sale will depend on the type of corporation that is issuing the stock options. Note that when the appropriate event triggers recognition of this income inclusion, it will be classified as employment income, even if the taxpayer is no longer an employee of the organization that issued the options.

**Taxable Income Deduction** As many of you are aware, gains on dispositions of securities are considered to be capital gains, subject to taxation on only one-half of their total amount. In the absence of some mitigating provision, the full amount of the employment income inclusion that arises on the exercise of options would be subject to tax. As this would not be an equitable situation, tax legislation permits a deduction in the calculation of Taxable Income equal to one-half of the employment income

inclusion. While general coverage of Taxable Income is found in Chapters 4 and 11, this deduction will be covered here as part of our discussion of stock options. Note, however, this deduction does not influence the calculation of Net Employment Income. This means that, if you are solving a problem that requires the calculation of Net Employment Income, you will **NOT** include this deduction in your calculation.

**Capital Gains** With the difference between fair market value at the exercise date and the option price being treated as an employment income inclusion, fairness requires that the adjusted cost base of the acquired shares be based on their fair market value at the exercise date, not the actual cost to the employee. This means that, when the shares are eventually sold, there will be a capital gain or loss based on the difference between the sale price and the fair market value of the shares at the time of exercise. As is discussed more fully in Chapter 8, only one-half of capital gains are subject to tax (the "taxable capital gain"). One-half of capital losses are deductible (the "allowable capital loss"), but only to the extent that there are taxable capital gains in the year.

3-165. A simple example will serve to illustrate the relevant calculations:

**EXAMPLE** An executive receives options to acquire 1,000 of his employer's common shares at an option price of $25 per share. At this time, the common shares are trading at $25 per share. He exercises the options when the shares are trading at $40 per share. In the following year, he sells the shares for $50 per share.

**ANALYSIS** Assuming that the employment income inclusion must be recognized when the options are exercised, the tax consequences for the year of exercise would be as follows:

| | |
|---|---|
| Employment Income [(1,000)($40 - $25)] Included In Net Income For Tax Purposes | $15,000 |
| Taxable Income Deduction (One-Half) | ( 7,500) |
| Taxable Income In Year Of Exercise | $ 7,500 |

When the shares are sold, the additional tax consequences to the employee would be as follows:

| | |
|---|---|
| Proceeds Of Disposition [(1,000)($50)] | $50,000 |
| Adjusted Cost Base [(1,000)($40)] | ( 40,000) |
| Capital Gain | $10,000 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain In Year Of Sale Included In Net Income For Tax Purposes | $ 5,000 |

3-166. Several points should be made with respect to this example:

- The employment income inclusion will always be measured at the time the options are exercised. However, its recognition for tax purposes may be deferred until the acquired shares are sold. This will be discussed in more detail in the material that follows.
- The $7,500 deduction is from Net Income For Tax Purposes in the calculation of Taxable Income, not from employment income. The net employment income that will be included in the executive's current or future Net Income For Tax Purposes, as well as his Earned Income inclusion for RRSP purposes (see Chapter 10), is $15,000.
- The availability of the $7,500 deduction requires that certain conditions be met. These conditions will be discussed in detail in the material that follows.
- As we have noted, when the $15 per share employment income benefit is included in employment income, this amount will be added to the adjusted cost base of the

shares, increasing their value to $40 per share ($25 + $15). This inclusion is provided for under ITA 53(1)(j).

## CCPCs Vs. Public Companies

3-167. As is discussed more fully in Chapter 12, "Taxable Income And Tax Payable For Corporations", a Canadian controlled private corporation (CCPC) is generally a corporation that is controlled by Canadian residents and does not have its shares traded on a prescribed stock exchange. This is an important distinction in many areas of tax work. However, our concern here is with the difference between the tax treatment of stock options issued by public companies and the tax treatment of stock options issued by CCPCs.

3-168. In very simplified terms, for options issued by public companies, the general rule is that the employment income inclusion will be recognized and taxed when the options are exercised. In contrast, for options issued by Canadian controlled private corporations, the employment income inclusion is still measured when the options are exercised, but the benefit is not taxed until the acquired shares are sold.

3-169. This clearly places individuals receiving stock options to acquire shares of public companies at a disadvantage. They are required to pay taxes on an unrealized amount of income, sometimes resulting in a need to dispose of some portion of the acquired shares. The main reason for the difference in the treatment of stock options for public companies and CCPCs is that, unlike public company shares, CCPC shares are usually difficult to convert to cash as there is no established market for private company shares. If the stock option benefit was taxed for CCPCs when the options are exercised, (as is the case for public companies), there would be no way the employee could sell a portion of the shares to pay the tax liability.

## Rules For Public Companies

3-170. Under ITA 7(1)(a), when options to acquire the shares of a publicly traded company are exercised, there is an employment income inclusion equal to the excess of the fair market value of shares acquired over the price paid to acquire them. A deduction from Taxable Income, equal to one-half of the employment income that is included under ITA 7(1)(a), can be taken under ITA 110(1)(d).

3-171. Note, however, this ITA 110(1)(d) deduction in the calculation of Taxable Income is only available if, at the time the options are issued, the option price was equal to, or greater than, the fair market value of the shares at the option grant date. If the option price is less than the fair market value of the shares at the time of issue, the deduction will not be available and the individual will be subject to tax on the full amount of the employment income inclusion.

**EXAMPLE** On December 31, 2017, John Due receives options to buy 10,000 shares of his employer's common stock at a price of $25 per share. The employer is a publicly traded company and the options are exercisable as of their issue date. At this time, the shares are trading at $25 per share. On July 31, 2019, the shares are trading at $43 per share and Mr. Due exercises all of these options. On September 30, 2020, Mr. Due sells all of his shares for $45 per share.

**ANALYSIS** The tax consequences for Mr. Due of these events and transactions are as follows:

- **Issue Date** (December 31, 2017)
  Despite the fact that the options clearly have a positive value at this point in time, there are no tax consequences resulting from the issuance of the options.

- **Exercise Date = Measurement and Recognition Date** (July 31, 2019)
  As the option price was equal to the fair market value of the shares at the option grant date, Mr. Due can use the ITA 110(1)(d) deduction in calculating his Taxable Income. The tax consequences resulting from the exercise of the options would be as follows:

| | |
|---|---|
| Fair Market Value Of Shares Acquired [(10,000)($43)] | $430,000 |
| Cost Of Shares [(10,000)($25)] | ( 250,000) |
| ITA 7(1)(a) Employment Income Inclusion<br>= **Increase In Net Income For Tax Purposes** | **$180,000** |
| ITA 110(1)(d) Deduction [(1/2)($180,000)] | ( 90,000) |
| **Increase In Taxable Income** | **$ 90,000** |

- **Disposition Date** (September 30, 2020)
  The tax consequences resulting from the sale of the shares would be as follows:

| | |
|---|---|
| Proceeds Of Disposition [(10,000)($45)] | $450,000 |
| Adjusted Cost Base [(10,000)($43)] | ( 430,000) |
| Capital Gain | $ 20,000 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain | $ 10,000 |

Note that, in the 2020 calculation, the adjusted cost base of the shares has been bumped up to the value of the shares at the time of exercise, reflecting the fact that the difference between the $43 per share value on that date and the $25 option price has already been included in the taxpayer's Net Income For Tax Purposes.

Also note that, if the taxpayer had sold the shares in 2020 for less than the $43 value that was established at the time of exercise in 2019, the result would be a capital loss. If this was the case, the taxpayer would not be able to deduct the loss in 2020, unless he had capital gains from some other source. This creates a situation that could be viewed as unfair in that the taxpayer has had to include gains up to the $43 value, but might not be able to deduct the loss resulting from a subsequent decline in value. Note that he cannot carry back the capital loss against the 2019 gain because that amount was classified as employment income, not as a capital gain.

### Exercise Three - 14

**Subject:** Stock Options - Public Company

During October, 2017, Mr. Gordon Guise was granted options to buy 2,500 of his employer's shares at a price of $23.00 per share. At this time, the shares are trading at $20.00 per share. His employer is a large publicly traded company. During July, 2019, he exercises all of the options when the shares are trading at $31.50 per share. In September, 2019, the shares are sold for $28.00 per share. What is the effect of the exercise of the options and the sale of the shares on Mr. Guise's 2019 Net Income For Tax Purposes and on his Taxable Income? Identify these two amounts separately.

**SOLUTION available in print and online Study Guide.**

## Rules For Canadian Controlled Private Corporations (CCPCs)

3-172. The basic public company rules that we have just described require the recognition of a taxable benefit when the options are exercised, prior to the realization in cash of any benefit from the options granted. This may not be an insurmountable problem for employees of publicly traded companies, in that they can sell some of the shares or use them as loan collateral if they need to raise the cash to pay the taxes on the benefit.

3-173. However, for employees of a Canadian controlled private corporation (CCPC), a requirement to pay taxes at the time an option is exercised could create severe cash flow problems since the shares are not publicly traded. As a consequence, a different treatment is permitted for stock options issued by CCPCs. The employment income inclusion is still measured at the time the options are exercised, but it is not taxed until the shares are sold.

3-174. For CCPCs, the employment income inclusion is determined under ITA 7(1)(a) and 7(1.1). The ITA 110(1)(d) deduction from Taxable Income is also available to CCPCs provided the option price was equal to, or more than, the fair market value of the shares at the option grant date. However, if this condition is not met, an additional provision under ITA 110(1)(d.1) allows the taxpayer to deduct one-half of the employment income inclusion, provided the shares are held for at least two years after their acquisition.

3-175. Using the same information that is contained in the example in Paragraph 3-171, altered only so that the employer is a CCPC, the tax consequences would be as follows:

**ANALYSIS FOR CCPC EXAMPLE**

- **Issue Date** (December 31, 2017)
  Despite the fact that the options clearly have a positive value at this point in time, there are no tax consequences resulting from the issuance of the options.

- **Exercise Date = Measurement Date Only** (July 31, 2019)
  While the amount of the employment income inclusion would be measured on this date, it would not be included in income at this point. Based on the increase in share value from $25 to $43 per share, the benefit would be measured as $180,000 [($43 - $25)(10,000 Shares)]. This benefit, along with the related $90,000 Taxable Income deduction, would be deferred until such time as the shares are sold.

- **Disposition Date = Recognition Date** (September 30, 2020)
  The tax consequences resulting from the sale of the shares would be as follows:

| | | |
|---|---|---|
| Deferred Employment Income<br>[($43 - $25)(10,000)] | | $180,000 |
| Proceeds Of Disposition [(10,000)($45)] | $450,000 | |
| Adjusted Cost Base [(10,000)($43)] | ( 430,000) | |
| Capital Gain | $ 20,000 | |
| Inclusion Rate | 1/2 | 10,000 |
| **Increase In Net Income For Tax Purposes** | | **$190,000** |
| ITA 110(1)(d) Deduction [(1/2)($180,000)] | | ( 90,000) |
| **Increase In Taxable Income** | | **$100,000** |

3-176. Note that this is the total increase in Taxable Income that would have resulted from simply purchasing the shares at $25 and later selling them for $45 [(10,000)(1/2)($45 - $25) = $100,000]. The structuring of this increase is different and, in some circumstances, the difference could be significant. For example, the fact that the $180,000 increase in value has been classified as employment income rather than capital gains means that it is not eligible for the lifetime capital gains deduction (see Chapter 11), but it will increase Earned Income for RRSP purposes (see Chapter 10). Although the timing is different, the $100,000 total increase in Taxable Income is the same as in the public company example in Paragraph 3-171.

**Exercise Three - 15**

**Subject:** Stock Options - CCPC

In December, 2017, Ms. Milli Van was granted options to buy 1,800 of her employer's shares at a price of $42.50 per share. At this time, the shares have a fair market value of $45.00 per share. Her employer is a Canadian controlled private corporation. In June, 2018, when the shares have a fair market value of $75.00 per share, she exercises all of her options. In September, 2019, Ms. Van sells her shares for $88,200 ($49.00 per share). What is the effect of the exercise of the options and the sale of the shares on Ms. Van's 2018 and 2019 Net Income For Tax Purposes and her Taxable Income? Identify these two amounts separately.

**SOLUTION available in print and online Study Guide.**

**We suggest you work Self Study Problems Three-7, 8 and 9 at this point.**

# Other Inclusions

## Payments By Employer To Employee

3-177. As noted in Paragraph 3-58, ITA 6(3) deals with employment related payments made prior to, or subsequent to, the employment period. This includes payments for accepting employment, as well as contractually arranged payments for work to be completed subsequent to the termination of employment. ITA 6(3) requires that all such amounts be included in employment income.

## Forgiveness Of Employee Loans

3-178. There may be circumstances in which an employer decides to forgive a loan that has been extended to an employee. As noted in Paragraph 3-58, ITA 6(15) requires that the forgiven amount be included in the income of the employee in the year in which the forgiveness occurs. The forgiven amount is simply the amount due, less any payments that have been made by the employee.

## Housing Loss Reimbursement

3-179. When an employee is required to move, employers often provide various types of financial assistance. As is discussed in detail in Chapter 9, an employer can pay for the usual costs of moving (e.g., shipping company costs) without tax consequences to the employee. In recent years, particularly when an employee is moved from an area with a weak housing market, it has become more common for employers to reimburse individuals for losses incurred in the disposition of their principal residence.

3-180. There is a limit on the amount of housing loss that can be reimbursed without tax consequences. This is accomplished in ITA 6(19) by indicating that amounts paid to employees for housing losses, except for amounts related to "eligible housing losses", must be included in income.

3-181. ITA 6(22) defines an "eligible housing loss" as a loss that is related to a move that qualifies for the deduction of moving expenses. While this issue is discussed in more detail in Chapter 9, we would note here that an employee is generally allowed to deduct moving expenses when he moves at least 40 kilometers closer to a new work location.

3-182. ITA 6(20) limits the amount of housing loss reimbursement that can be received by indicating that one-half of any amount received in excess of $15,000 as an eligible housing loss must be included in the employee's income as a taxable benefit. Stated alternatively, the

tax free amount of housing loss reimbursement is limited to the first $15,000, plus one-half of any amount paid in excess of $15,000.

### Discounts On Employer's Merchandise

3-183. As noted in Paragraph 3-63, when an employee is allowed to purchase merchandise which is ordinarily sold by an employer, any discount given to the employee is not generally considered to be a taxable benefit. If discounts are extended by a group of employers, or if an employer only extends the discounts to a particular group of employees, a taxable benefit may arise. In addition, this administrative position is not intended to apply to big-ticket items (e.g., a contractor giving an employee a discount on a new home).

3-184. A further interesting note is that the CRA has indicated that, in the case of airline employees, a benefit is assessed if the employee travels on a space confirmed basis and pays less than 50 percent of the economy fare. The benefit is the difference between 50 percent of the economy fare and the amount paid.

3-185. When a benefit must be included in income as the result of merchandise discounts, it will include any GST/HST that is applicable to these amounts.

## Specific Deductions

### Overview

3-186. The provisions covering deductions that can be made against employment income are found in ITA 8. In addition, ITA 8(2) contains a general limitation statement that makes it clear that unless an item is listed in ITA 8, it cannot be deducted in the calculation of employment income.

3-187. We have noted previously that the ITA 8 list of deductions is very limited, particularly in comparison with the list of deductions available to self-employed individuals earning business income. Despite the shortness of its list, the application of ITA 8 is fairly complex. This results from the fact that there are restrictions on the type of employee that can deduct certain items, on the items that can be deducted, and on the simultaneous use of some of the statutory provisions. Given this complexity, a listing and brief description of the more significant deductions available is a useful introduction to this material.

**ITA 8(1)(b) Legal Expenses** allows an employee to deduct any legal costs paid to collect or establish the right to salary or wages owed by an employer or former employer. Also deductible are legal costs incurred to recover benefits, such as health insurance, that are not paid by an employer or former employer, but that are required to be included in employment income when received.

**ITA 8(1)(f) Sales Expenses** covers the deductions available to individuals who earn commission income. It covers travel expenses, motor vehicle expenses, and other types of expenses associated with earning commissions (e.g., licenses required by real estate salespersons).

**ITA 8(1)(h) Travel Expenses** covers deductions available to all employees for travel expenses, other than motor vehicle expenses. An employee earning commissions can deduct travel costs under ITA 8(1)(f) or ITA 8(1)(h), but cannot use both provisions simultaneously.

**ITA 8(1)(h.1) Motor Vehicle Travel Expenses** covers deductions available to all employees for motor vehicle expenses. An employee earning commissions can deduct motor vehicle costs under ITA 8(1)(f) or ITA 8(1)(h.1), but cannot use both provisions simultaneously.

**ITA 8(1)(i) Dues And Other Expenses Of Performing Duties** covers a variety of deductions available to all employees. Included here would be professional dues, office rent paid or costs of maintaining a work space in the home, salaries to an assistant, and the cost of supplies used in employment related activities.

**ITA 8(1)(j) Motor Vehicle And Aircraft Costs** In general, employees cannot deduct capital costs. This includes tax depreciation (capital cost allowance or CCA) and interest on funds borrowed to acquire capital assets. This Paragraph creates an exception for motor vehicles and aircraft used in employment activities. Both CCA and financing costs on these assets can be deducted under this provision.

**ITA 8(1)(p) Musical Instruments** This is a second exception to the general rule that employees cannot deduct capital costs. This Paragraph allows the deduction of CCA on musical instruments required by employment activities. Unlike the provision for motor vehicle and aircraft costs, this provision does not allow the deduction of interest related to the financing of such instruments.

**ITA 8(1)(m) Employee's Registered Pension Plan (RPP) Contributions** As was noted previously, ITA 6(1)(a) excludes employer's contributions to an RPP from treatment as a taxable benefit. Adding to the attractiveness of these arrangements is the fact that ITA 8(1)(m) provides for the employee's contributions to be treated as a deduction. This deduction is given detailed attention in Chapter 10 which provides comprehensive coverage of the various retirement savings arrangements.

**ITA 8(1)(r) Apprentice Mechanic's Tool Costs** provides for the deduction of tools that are required by an apprentice mechanic. This is a very complex provision that allows for a deduction of costs in excess of an annual threshold amount. The threshold is the lesser of \$500 plus the Canada employment credit amount (see Chapter 4), and 5 percent of an adjusted income figure.

**ITA 8(1)(s) Tradesperson's Tool Expenses** provides for the deduction of up to \$500 for tools that are required by a tradesperson. Only costs in excess of \$1,222 can be deducted. As noted in Chapter 4, this amount is also the base for the Canada Employment Tax Credit.

**ITA 8(4) Meals** Both ITA 8(1)(f) and ITA 8(1)(h) refer to travel costs. As such costs could include meals, ITA 8(4) specifies when meals can be considered a part of travel costs. This Subsection notes that, for meals to be deductible by an individual taxpayer as travel costs under ITA 8(1)(f) or ITA 8(1)(h), the meals must be consumed when the taxpayer is required, by his employment duties, to be away from the municipality or metropolitan area where his employer's establishment is located for at least 12 hours.

We would also note here that ITA 67.1(1) limits the deductibility of food and entertainment costs to 50 percent of the amount paid. This limitation applies without regard to whether the individual is working as an employee, or as a self-employed individual earning business income. (See Note On Meals at the end of Paragraph 3-190.)

**ITA 8(13) Work Space In Home** provides rules for an employee deducting the costs of a work space in his home (a.k.a. home office costs).

3-188. Most of these provisions will be given more detailed attention in the material in this Chapter. The Employee and Partner GST Rebate available on deductible expenses is covered in Chapter 21. Other, less commonly used Paragraphs such as ITA 8(1)(e) which allows the deduction of certain expenses of railway employees, will not be given coverage.

## Salesperson's Expenses Under ITA 8(1)(f)

3-189. Individual employees who are involved with the selling of property or the negotiating of contracts are permitted to deduct all expenses that can be considered necessary to the performance of their duties. As stated in ITA 8(1)(f), to be eligible to deduct salesperson's expenses, all of the following conditions must be met:

1. The salesperson must be required to pay his own expenses. The employer must sign Form T2200 certifying that this is the case. While the form does not have to be filed, it must be available if requested by the CRA.
2. The salesperson must be ordinarily required to carry on his duties away from the employer's place of business.
3. The salesperson must not be in receipt of a travel allowance that was not included in income.
4. The salesperson must receive at least part of his remuneration in the form of commissions or by reference to the volume of sales.

3-190. Items that can be deducted under ITA 8(1)(f) include:

- advertising and promotion
- meals with clients (see note which follows)
- lodging
- motor vehicle costs (other than CCA and interest)
- parking (which is not considered a motor vehicle expense)
- work space in the home costs (see the discussion in Paragraph 3-207).
- training costs
- transportation costs
- licences (e.g., for real estate sales)
- bonding and liability insurance premiums
- computers and office equipment (leased only - see following Paragraph)

**Note On Meals** The ITA 8(4) provision which states that a taxpayer can only deduct meals when he is away from his municipality for at least 12 hours does not apply to meals paid for clients by a salesperson who earns commissions. Technically, it continues to apply to the salesperson's share of the meal cost. This would require separate bills for the portion of the cost allocated to the salesperson and client(s).

However, it is unlikely that this distinction is enforced in practice. Given this, in our examples and problems we will assume that, subject to the 50 percent limitation, the full cost of meals with clients would be deductible.

3-191. Except in the case of an automobile or aircraft, an employee who is a salesperson cannot deduct CCA or interest on funds borrowed to acquire capital assets. This means that if a salesperson purchases a computer to maintain customer records, he will not be able to deduct CCA on it. Alternatively, if the computer is leased, the lease payments are deductible.

3-192. As is the case in the determination of business income, no deduction is permitted for membership fees for clubs or recreational facilities. A salesperson is permitted to deduct motor vehicle costs, supplies, salaries to an assistant, office rent and the cost of maintaining an office in his home. However, these costs can also be deducted by other types of employees and, as a consequence, will be dealt with later in this Chapter.

3-193. The amount of qualifying expenses that can be deducted under ITA 8(1)(f) is limited to the commissions or other sales related revenues received during the year. This limitation does not, however, apply to CCA or interest on a motor vehicle or aircraft. These costs are deductible under ITA 8(1)(j) (see Paragraph 3-204). The deduction under ITA 8(1)(j) is not limited to commission income and, because it can be used in conjunction with ITA 8(1)(f), the salesperson's total deductions can exceed commission income.

## Travel Expenses And Motor Vehicle Costs Under ITA 8(1)(h) and 8(1)(h.1)

3-194. The conditions for deducting expenses under ITA 8(1)(h) and (h.1) are similar to those for deductions under ITA 8(1)(f), except that there is no requirement that some part of the employee's remuneration be in the form of commissions. The conditions are as follows:

1. The person must be required to pay his own travel and motor vehicle costs. As was the case with commission salespersons, the employee must have Form T2200, signed by the employer, certifying that this is the case.

2. The person must be ordinarily required to carry on his duties away from the employer's place of business.

3. The person must not be in receipt of an allowance for travel costs that was not included in income.

3-195. There is one further condition that will be discussed more fully beginning at Paragraph 3-199. Both ITA 8(1)(h) and (h.1) state that, if a deduction is made as a salesperson under ITA 8(1)(f), no deduction can be made under either ITA 8(1)(h) or 8(1)(h.1).

3-196. ITA 8(1)(h) provides for the deduction of travel costs such as accommodation, airline or rail tickets, taxi fares, and meals. As was the case with salespersons' expenses, only 50 percent of the cost of meals is deductible. Here again, the deductibility of meals is conditional on being away from the municipality or metropolitan area in which the employer's establishment is located for at least 12 hours.

3-197. ITA 8(1)(h.1) provides for the deduction of motor vehicle costs, other than CCA and financing costs, when an employee pays the operating costs of a vehicle used to carry out employment duties. Note that these are the same costs that could be deducted by a salesperson under ITA 8(1)(f).

3-198. These deductions can be claimed by any employee who meets the specified criteria. Further, they are not limited by employment income. The deductions can be used to create a net employment loss which, if not usable against other types of income in the current year, is subject to the carry forward provisions that are discussed in Chapter 11.

## The Salesperson's Dilemma

3-199. All of the travel and motor vehicle costs that a salesperson could deduct under ITA 8(1)(h) and (h.1) could also be deducted using ITA 8(1)(f). However, the use of ITA 8(1)(f) involves both good news and bad news:

- **Good News** The good news is that, if the salesperson uses ITA 8(1)(f), he can deduct expenses related to sales activity that are not deductible under any other provision (e.g., advertising and promotion).

- **Bad News** The bad news is that, if a salesperson uses ITA 8(1)(f), the amount that he can deduct is limited to the amount of commission income.

3-200. At first glance, the logical course of action here would be to use ITA 8(1)(h) and (h.1) for the travel and motor vehicle costs (this deduction would not be limited by commission income), and to then use ITA 8(1)(f) to deduct the maximum amount of other items that are available under this latter Paragraph (subject to the commission income limitation). However, this cannot be done — the *Income Tax Act* prohibits the use of ITA 8(1)(h) or (h.1), if a deduction is made under ITA 8(1)(f).

3-201. The result is, in situations where potential deductions under ITA 8(1)(f) exceed commission income, the salesperson must undertake an additional calculation to determine whether the total travel costs under ITA 8(1)(h) and (h.1) would be greater than the commission limited amount of deductions under ITA 8(1)(f). Should this be the case, the salesperson would deduct the larger amount that is available under ITA 8(1)(h) and (h.1). It is difficult to understand the tax policy goal that is achieved through this complexity.

3-202. Note that this choice does not influence the amount of other deductions available to the salesperson. The amounts deducted under other ITA 8(1) Paragraphs will be unchanged by whether the salesperson uses ITA 8(1)(f) or the combination of ITA 8(1)(h) and (h.1).

**Exercise Three - 16**

**Subject:** Commission Salesperson Expenses

Mr. Morton McMaster is a commission salesperson. During 2019, his gross salary was $82,000 and he received $12,200 in commissions. During the year he had advertising costs of $8,000 and expenditures for entertainment of clients of $12,000. His travel costs for the year totaled $13,100. He is required to pay his own expenses and does not receive any allowance from his employer. What is Mr. McMaster's maximum expense deduction for 2019?

**SOLUTION available in print and online Study Guide.**

## Other Expenses Of Performing Duties Under ITA 8(1)(i)

3-203. ITA 8(1)(i) contains a list of other items that can be deducted in the determination of employment income by all employees. The major items included here are as follows (see IT-352R2, "Employee's Expenses, Including Work Space in Home Expenses", for more detailed coverage):

- Annual professional membership dues, if their payment was necessary to maintain a professional status recognized by statute.
- Union dues that are paid pursuant to the provisions of a collective agreement.

In order to deduct the following amounts, the employee must be required to incur the costs under a contract of employment. This must be supported by Form T2200, signed by the employer and certifying that the requirement exists.

  - Office rent, including in the case of work space in the home, an appropriate portion of the rent paid for the taxpayer's residence (see Paragraph 3-207).
  - Salary paid to an assistant or a substitute.
  - The cost of supplies consumed in the performance of employment duties. Supplies in this context include stationery, long distance telephone calls and cell phone airtime, but not the basic monthly charge for a telephone or amounts paid to connect or license a cell phone. Note that IT-352R2 indicates that the term supplies includes maintenance and operating costs associated with a work space in the home.

## Automobile And Aircraft Expenses Under ITA 8(1)(j)

3-204. Under either ITA 8(1)(f) or ITA 8(1)(h.1) an employee can deduct the operating costs of an automobile used in employment duties. With respect to operating costs, this would include an appropriate share (based on the proportion the employment related kilometers are of the total kilometers driven) of such costs as fuel, maintenance, normal repair costs, insurance, and licensing fees.

3-205. In addition, under ITA 8(1)(j), an employee can deduct CCA and interest costs on an automobile, or an aircraft, that is used in employment related activities. The deductible amounts for CCA are calculated in the same manner as they would be for a business. CCA would be calculated on a 30 percent declining balance basis on automobiles and a 25 percent declining balance basis on aircraft, while deductible interest would be based on actual amounts paid or payable. (See Chapter 5 for complete coverage of CCA calculations.) With respect to interest calculations, there is a difference in that, while a business can deduct accrued interest, an employee can only deduct interest that has been paid.

3-206. However, there are limits on the amounts that can be deducted here for business purposes, and these limits are equally applicable to the calculation of employment income deductions. While these limits are discussed more completely in Chapter 6 on Business Income, we would note here that for 2019 there is no deduction for CCA on the cost of an

automobile in excess of $30,000 (before GST/HST/PST), that deductible interest is limited to $300 per month, and that deductible lease payments are limited to $800 per month (before GST/HST/PST). With respect to employees, their deduction would be based on the fraction of these costs, subject to the preceding limits, that reflects the portion of employment related kilometers included in the total kilometers driven.

## Work Space In The Home Costs For Employees

3-207. We have noted previously that any employee who is required by his employment contract to maintain a work space in the home can deduct a portion of the costs of maintaining or renting his home. Because of the obvious potential for abuse in this area, ITA 8(13) establishes fairly restrictive conditions with respect to the availability of this deduction. Costs of a work space in the home for an employee are only deductible when the work space is either:

- the place where the individual principally performs the duties of the office or employment, or
- used exclusively during the period in respect of which the amount relates for the purpose of earning income from the office or employment and used on a regular and continuous basis for meeting customers or other persons in the ordinary course of performing the duties of the office or employment.

3-208. Once it is established that work space in the home costs are deductible, it becomes necessary to determine what kind of costs can be deducted. We have noted previously that, for employees, the only assets on which CCA and interest can be deducted are automobiles and aircraft. CCA can be deducted on musical instruments, but not interest on loans to purchase them. This means that no employee can deduct CCA or mortgage interest related to an office that is maintained in their residence. (Chapter 6 contains a comparison of deductible home office costs for employees and for self-employed contractors.)

3-209. With respect to other costs, IT-352R2 indicates that under ITA 8(1)(i) an employee can deduct an appropriate portion (based on floor space used for the work space) of maintenance costs such as fuel and electricity, light bulbs, cleaning materials, and minor repairs. The cost of telephone and internet service are considered to be supplies and do not relate to the work space. Employees cannot deduct the monthly basic cost of a home telephone or the cost of fees for home internet service. Long distance charges that reasonably relate to employment income are deductible.

3-210. For commissioned salespersons who can deduct work space in the home costs, IT-352R2 indicates that, in addition to the items listed in the preceding paragraph, an appropriate portion of property taxes and house insurance premiums can be deducted under ITA 8(1)(f). This means that, for commissioned salespersons, the deduction for work space in the home costs is split between ITA 8(1)(i) and (f). The insurance and property tax components could be limited by commission income as they can only be deducted under ITA 8(1)(f).

3-211. If the home office is in rented property, the percentage of rent and any maintenance costs paid related to the work space are deductible.

3-212. The amount deductible for work space in the home costs is limited to employment income after the deduction of all other employment expenses. Stated alternatively, work space in the home costs cannot be used to create or increase an employment loss. Any work space in the home costs that are not deductible in a year can be carried forward to the following year. In effect, there is an indefinite carry forward of these costs as they are rolled forward and become part of the work space in the home costs for the following year. This continues until there is sufficient employment income from the same employer to deduct them.

**We suggest you work Self Study Problems Three-10 through 14 at this point.**

**Additional Supplementary Self Study Problems Are Available Online.**

## Key Terms Used In This Chapter

3-213. The following is a list of the key terms used in this Chapter. These terms, and their meanings, are compiled in the Glossary located at the back of the Study Guide.

| | |
|---|---|
| Allowance | Operating Cost Benefit |
| Bonus Arrangement | Prescribed Rate |
| Canadian Controlled Private Corporation | Public Corporation |
| Employee | Salary |
| Employer/Employee Relationship | Self-Employed Individual |
| Employment Income | Standby Charge |
| Fringe Benefits | Stock Option |
| Home Relocation Loan | Taxable Allowance |
| Imputed Interest | Taxable Benefit |
| In-The-Money | |

## References

3-214. For more detailed study of the material in this Chapter, we would refer you to the following:

| | |
|---|---|
| ITA 5 | Income From Office Or Employment |
| ITA 6 | Amounts To Be Included As Income From Office Or Employment |
| ITA 7 | Agreement To Issue Securities To Employees |
| ITA 8 | Deductions Allowed |
| ITA 80.4 | Loans |
| ITA 80.5 | Deemed Interest |
| ITR 4301 | Interest Rates [Prescribed Rate Of Interest] |
| S2-F1-C1 | Health And Welfare Trusts For Employees |
| S2-F3-C1 | Payments from Employer to Employee |
| S2-F3-C2 | Benefits And Allowances Received From Employment (Under Review) |
| S4-F2-C2 | Business Use Of Home Expenses |
| IC 73-21R9 | Claims for Meals and Lodging Expenses of Transport Employees |
| IT-63R5 | Benefits, Including Standby Charge For An Automobile, From The Personal Use Of A Motor Vehicle Supplied By An Employer - After 1992 |
| IT-91R4 | Employment At Special Or Remote Work Locations |
| IT-99R5 | Legal And Accounting Fees (Consolidated) |
| IT-103R | Dues Paid To A Union Or To A Parity Or Advisory Committee |
| IT-113R4 | Benefits To Employees - Stock Options |
| IT-158R2 | Employees' Professional Membership Dues |
| IT-202R2 | Employees' Or Workers' Compensation |
| IT-352R2 | Employee's Expenses, Including Work Space in Home Expenses |
| IT-421R2 | Benefits To Individuals, Corporations And Shareholders From Loans Or Debt |
| IT-428 | Wage Loss Replacement Plans |
| IT-504R2 | Visual Artists And Writers (Consolidated) |
| IT-518R | Food, Beverages And Entertainment Expenses |
| IT-522R | Vehicle, Travel and Sales Expenses of Employees |
| IT-525R | Performing Artists |
| RC4110 | CRA Guide - Employee Or Self-Employed? |
| T4044 | Employment Expenses |
| T4130 | Employers' Guide – Taxable Benefits and Allowances |

# Problems For Self Study (Online)

To provide practice in problem solving, there are Self Study and Supplementary Self Study problems available on MyLab Accounting.

Within the text we have provided an indication of when it would be appropriate to work each Self Study problem. The detailed solutions for Self Study problems can be found in the print and online Study Guide.

We provide the Supplementary Self Study problems for those who would like additional practice in problem solving. The detailed solutions for the Supplementary Self Study problems are available online, not in the Study Guide.

The .PDF file "Self Study Problems for Volume 1" on MyLab contains the following for Chapter 3:

- 14 Self Study problems,
- 5 Supplementary Self Study problems, and
- detailed solutions for the Supplementary Self Study problems.

# Assignment Problems

(The solutions for these problems are only available in the solutions manual that has been provided to your instructor.)

### *Assignment Problem Three - 1*

#### *(Bonus Arrangements)*

Marques Ltd. is a Canadian public company with a taxation year that ends on November 30. Its shares are widely held. However, its senior management is made up of the four Marques brothers. As the year ending November 30, 2019 has been very successful for the Company, it is declaring a bonus to each of the four senior executives. All of the bonuses are declared on November 29, 2019. The details of these arrangements are as follows:

> **Cheeco Marques** Cheeco is the CEO of the Company. Because of his conservative lifestyle, he has little current need for funds. Given this, his bonus will be paid on March 31, 2025, his expected retirement date.
>
> **Zeppo Marques** Zeppo is the Vice President of Finance of the Company. While he is not pressed for current income, he would like to defer the personal payment of tax for as long as possible. Given this, his bonus will be paid on January 1, 2020.
>
> **Groucho Marques** Groucho is the Vice President of Human Resources of the Company. Unfortunately Groucho has been married and divorced six times, a fact that may be related to his hiring criteria for female associates. As a consequence, he is constantly in need of funds to maintain his required support payments. Based on this need, his bonus will be paid on December 1, 2019.
>
> **Harpo Marques** Harpo, who is in charge of information technology for the company, plans to leave the company in mid-2020. It has always been his dream to pursue a musical career and, to that end, he will need funds to carry him through the early stages of that endeavour. Given this, his bonus will be paid on September 1, 2020.

**Required:** For each of these brothers, indicate the taxation year in which the Company can deduct the bonus, as well as the taxation year in which the recipient will include it in his tax return.

## Assignment Problem Three - 2

### *(Employee Vs. Self-Employed)*

The Alberta Motor Association (the Payor) carried on a business of training and providing instruction to individuals who wanted to obtain vehicle operator's licenses. Mr. Bourne (the Appellant) had an arrangement with the Payor to provide such instruction.

The Payor had treated Mr. Bourne as an independent contractor from 2017 to 2019. Mr. Bourne was claiming that he was an employee of the Alberta Motor Association in 2019.

The facts in this case are as follows:

- the Payor operated as a membership based association; (admitted)
- the Payor had clients who wanted to obtain motor vehicle operator's licences; (admitted)
- the Appellant was hired as a driving instructor; (admitted)
- the Appellant entered into a written contract with the Payor which stated that the Appellant was a contractor and not an employee;
- the Appellant had been under contract with the Payor since 2017;
- the Appellant earned a set fee of $26 per hour;
- the Appellant also received fees for new bookings, student home pickups and a fuel subsidy;
- the Appellant invoiced the Payor;
- the Appellant did not receive any employee benefits such as health, dental or vacation pay;
- the Payor did not guarantee the Appellant a minimum amount of pay;
- the Payor's hours of operation were from 8:00AM to 5:00PM, Monday to Saturday;
- the Appellant set his own schedule of hours and days of work;
- the Appellant could work anytime between 8:00AM and 10:00PM, Monday to Sunday;
- the Appellant did not have a set minimum number of hours of work required;
- the Appellant kept a record of his hours worked;
- the Payor provided the Appellant with the names of the students;
- the Appellant contacted the students and scheduled the road instruction;
- the Payor provided the Appellant with an in-vehicle lesson guide;
- the Appellant chose the routes for the lessons;
- the Appellant was able to hire his own helper for administrative tasks;
- the Appellant provided the major tool which was the vehicle;
- the Payor provided vehicle signage, mirrors, traffic cones and an emergency brake;
- the Appellant paid for the installation and removal of the emergency brake provided by the Payor;
- the Appellant incurred operating expenses including vehicle expenses, liability insurance and a driver training endorsement;
- the Appellant's vehicle expenses included insurance, maintenance and fuel;
- the Payor's intention was that the Appellant was a contractor and not an employee;
- the Appellant had a GST number;
- the Appellant charged the Payor GST;
- the Appellant had operated his own taxi business since 2001;
- the Appellant maintained his own business books and records;
- the Appellant declared business income and business expenses on his 2017, 2018 and 2019 income tax returns.

**Required**: Should Mr. Bourne be viewed as an employee of the Alberta Motor Association or, alternatively, an independent contractor? List all of the factors that should be considered in reaching a conclusion.

## Assignment Problem Three - 3

### *(Employer Provided Vs. Employee Owned Car)*

Jerry Field was hired by Larson Wholesalers at the end of 2018 to fill an executive position in the company. He is scheduled to begin work on January 2, 2019. Larson Wholesalers plans to transfer him to their Hong Kong office after two years.

As part of his compensation package, Jerry has considered having the Company provide him with a car for his personal use. He does not require the vehicle for his employment duties and, as a consequence, it will be used for personal activities only. Jerry anticipates that he will drive the car about 80,000 kilometers in both 2019 and 2020.

He is considering two different cars and has collected the following information on them:

| | Lexus ES | Lexus LS |
|---|---:|---:|
| Purchase Price | $45,000 | $100,000 |
| Estimated Operating Costs Per Kilometer | $0.30 | $0.40 |
| Estimated Trade In At The End Of 2 Years | $20,000 | $40,000 |

The Company has agreed to provide an additional $100,000 in compensation and they offer Jerry the following alternatives.

**Option 1** They will purchase either car and allow Jerry to use it for the calendar years 2019 and 2020. If Jerry prefers the Lexus ES, the Company will provide a signing bonus of $55,000, the difference in the cost of the two cars. The bonus will be paid when the car is delivered on January 2, 2019.

**Option 2** They will provide Jerry with an $100,000 signing bonus. This bonus will be paid on January 2, 2019. He will use the funds to purchase one of the cars personally.

If the Company buys either car, Jerry will pay his own operating costs and the Company will take possession of the car after the 2 years.

Jerry's combined federal/provincial marginal tax rate is expected to be 48 percent in both 2019 and 2020.

Assume that the prescribed operating cost benefit will be $0.28 per kilometer for both 2019 and 2020.

**Required**: Advise Jerry as to which option he should choose if decides that he wants:

A. the Lexus ES.
B. the Lexus LS.

In both parts of this question your advice should be based on non-discounted cash outflows. Ignore GST and HST considerations in your solution.

### *Assignment Problem Three - 4*

#### *(Taxable Automobile Benefits)*

The Jareau Manufacturing Company owns a car with an original cost of $30,000. The car has been owned by the Company for two years. Jareau requires that cars be returned to the corporate premises when they are not being used by the employee.

During 2019, the car has been used by the Company's sales manager, Mr. Robert Stickler. During this year, Mr. Stickler drove the car 36,000 kilometers, with all of the expenses being paid for by the Company. The operating costs paid for by the Company total $3,920. In addition, the Company deducted capital cost allowance of $5,610 related to this car for the current year.

**Required:** Ignore all GST/PST/HST implications. Indicate the minimum taxable benefit that would be allocated to Mr. Stickler in each of the following Cases:

**Case A** Mr. Stickler has use of the car for the entire year and drives it a total of 7,200 kilometers for personal purposes.

**Case B** Mr. Stickler has use of the car for 10 months of the year and drives it a total of 15,000 kilometers for personal purposes.

**Case C** Mr. Stickler has use of the car for 6 months of the year and drives it a total of 25,200 kilometers for personal purposes.

### Assignment Problem Three - 5

#### (Taxable Automobile Benefits)

It is the policy of Dorsey Ltd. to provide automobiles to four of their senior executives. The cars may be used for both employment related activities, as well as personal travel. When it is not being used by the employee, the Company requires the cars to be returned to the Company's garage.

For 2019, the details regarding the use of these cars is as follows:

**Ms. Marianne Dorsey** Marianne is the president of the Company. She is provided with a Bentley Flying Spur Sedan. The Company paid $185,000 for this car two years ago. During the current year, the car was driven 53,000 kilometers, of which 18,000 could be considered to be employment related travel. Operating costs, all of which were paid by the Company, totaled $27,500 for the year. The car was available to Marianne for 11 months of the year.

**Mr. John Dorsey** John is the vice president in charge of finance. His car is a BMW 528 purchased by the Company for $71,500. During the 10 months that the car was available to John during the current year, he drove a total of 93,000 kilometers, of which 22,000 involved personal travel. Operating costs, all of which were paid by the Company, total $18,600.

**Ms. Misty Dorsey** Misty is the vice president in charge of design. She is provided with an Infiniti Q60 IPL which the Company leases for $620 per month. This amount includes a $100 per month payment for insurance. The car is available to Misty throughout the current year, during which she drives a total of 51,000 kilometers. Of this total, only 14,000 kilometers involve employment travel. Operating costs, all of which were paid by the Company, total $11,300. Because of her extensive personal use of the vehicle, Misty pays the Company $200 per month.

**Mr. Saul Dorsey** Saul is the vice president in charge of marketing for the Company. He is provided with a Tesla Model S which the Company leases for $1,200 per month. No insurance is provided for through this payment. During the current year, Saul drives the car a total of 31,200 kilometers, of which 29,500 are employment related. The operating costs average $0.28 per kilometer and are paid for by the Company. The car is available to Jean for 8 months during the current year.

**Required:** Calculate the minimum taxable benefit that will accrue to each of these executives as the result of having the cars supplied by the Company. Ignore all GST/PST/HST implications.

### Assignment Problem Three - 6

#### (Loans To Employees)

Trisha Frude has been employed for over 20 years with a large public company. It is the policy of this company to extend interest free loans of up to $250,000 to facilitate employees with more than 10 years of service in purchasing a new home.

After living in a rental property for all of her working life, Trisha would like to purchase a residence. After considerable searching, she has located an attractive property within biking distance of her office with the company. In order to comfortably purchase this property, she needs a loan of $225,000.

Trisha has been approved for a 5 year closed mortgage at a rate of 4.8 percent from her bank. She also applied for a loan of this amount on an interest-free basis from her employer. After receiving her application, her employer has agreed to extend a 5 year, $225,000 loan on an interest-free basis in lieu of a (well deserved) raise.

The Company's accountant will calculate the after tax cost of providing the loan. Her employer will offer Trisha the alternative of additional salary that has the same after tax cost to the Company of the loan.

The Company is subject to tax at a combined federal/provincial rate of 27 percent. When funds are available, the Company has alternative investment opportunities that earn a pre-tax rate of 11 percent. Because of Trisha's current high salary, any additional compensation will be taxed at a combined federal/provincial rate of 49 percent.

Assume that the prescribed rate for the current year is 2 percent.

**Required:**

A. Determine the tax consequences to Trisha and the cost to the Company, in terms of lost after-tax earnings, of providing her with a $225,000 interest free loan for the first year of the loan.

B. Determine the amount of additional salary that could be provided to Trisha for the same after tax cost to the Company that you calculated in Part A.

C. Which alternative would you recommend that Trisha accept? Explain your conclusion.

### Assignment Problem Three - 7

#### (Loans To Employees)

Ms. Teresa Monson is employed by Elmwood Inc. She has asked the employer for a $300,000 interest free loan that will be used to acquire a summer cottage in Huntsville, Ontario. The cottage will be used exclusively as a recreational property. As she is a highly valued employee, Elmwood Inc. is considering her request.

Ms. Monson can acquire a regular mortgage at a rate of 4.5 percent. Assume that the relevant prescribed rate is 2 percent for all periods that the employee loan will be outstanding.

Ms. Monson's tax rate on any additional income is 46 percent. Elmwood Inc. has alternative investment opportunities that earn a before tax rate of 7 percent. Elmwood Inc. is subject to a tax rate of 28 percent on additional amounts of income.

**Required:** Evaluate Ms. Monson's suggestion of providing her with an interest free loan in lieu of salary from the point of view of the cost to Elmwood Inc.

### Assignment Problem Three - 8

#### (Employee Stock Options)

Floretta Sutphin has worked for several years as an employee of a Canadian public company. In 2017, Floretta was granted options to acquire 2,000 of the company's shares at a price of $19 per share. At that time, the shares were trading at $17 per share.

In February, 2018, with the shares trading at $27 per share, Floretta exercises 1,000 of the options. During the remainder of the year, the shares continue to increase in value, reaching a value of $32 per share in December. At this time, Floretta exercises the remaining 1,000 options.

In the second quarter of 2019, reflecting poor earnings results during the first quarter of the year, the value of the shares declines to $30 per share. At this point, Floretta sells all 2,000 of her shares at this price.

**Required:**

A. Indicate the tax effect of the transactions that took place during each of the years 2017, 2018, and 2019. Your answer should include the effect on both Net Income For Tax Purposes and Taxable Income. Where relevant, identify these effects separately.

B. How would your answer change if the shares had been trading at $22 per share at the time that the options were issued in 2017?

C. How would your answers to both Part A and Part B change if Floretta's employer was a Canadian controlled private company?

## Assignment Problem Three - 9

### (Employee Stock Options)

All of the long term employees of Salter Inc. are allowed to participate in the Company's stock option plan. In January , 2017, Sharon Poulter was granted options to acquire 410 Salter Inc. shares at a price of $32.00 per share.

At the time of exercise, the Salter Inc. shares have a fair market value of $37.80 per share.

On November 15, 2019, the 410 Salter Inc. shares are sold.

**Required:** Indicate the tax effect on Sharon of the transactions that took place during 2017, 2018, and 2019 under each of the following independent Cases. Your answer should include the effect on both Net Income For Tax Purposes and Taxable Income. Where relevant, identify these effects separately.

**Case 1** Salter Inc. is a Canadian controlled private company. At the time the options were granted, the Company's shares had a fair market value of $31.00 per share. The options are exercised on July 1, 2018. When the shares are sold, the proceeds of disposition are $45.80 per share.

**Case 2** Salter Inc. is a Canadian controlled private company. At the time the options were granted, the Company's shares had a fair market value of $34.00 per share. The options are exercised on February 28, 2017. When the shares are sold, the proceeds of disposition are $43.20 per share.

**Case 3** Salter Inc. is a Canadian public company. At the time the options were granted, the Company's shares were trading at $31.00 per share. The options are exercised on July 1, 2018. When the shares are sold, the proceeds of disposition are $42.10 per share.

**Case 4** Salter Inc. is a Canadian public company. At the time the options were granted, the Company's shares were trading at $34.00 per share. The options are exercised on February 28, 2018. When the shares are sold, the proceeds of disposition are $31.00 per share.

## Assignment Problem Three - 10

### (Employment Income)

Ms. Alexa Braxton has worked for AAAA Retailers for a number of years. AAAA is a Canadian controlled private corporation. It operates three children's clothing stores in the Edmonton area.

Her salary for the year 2019 was $120,000. AAAA withheld the following amounts from her earnings:

| | |
|---|---|
| Federal And Provincial Income Tax | $20,400 |
| EI Premiums | 860 |
| CPP Contributions | 2,749 |
| Private Health Care Plan - Employee Portion | 900 |
| Union Dues | 100 |

**Other Information:**

1. AAAA provided Alexa with a car to be used in her employment activities. In addition, the Company paid her 2019 operating costs of $10,250. The car was purchased, used, from a car dealer for $33,600, including GST of $1,600.

   The car was available to Alexa throughout 2019. During this period, she drove a total of 81,000 kilometers, 6,000 of which were for personal use.

2. Alexa earned the outstanding employee award for 2019. Besides a plaque, the award came with a cheque for $2,000 payable in January, 2020.

3. In renegotiating her future compensation with AAAA, Alexa had asked for a $25,000 interest free loan as one of her benefits. Because employee loans were not company policy, as an alternative she was granted options to buy 1,000 of the company's shares at $35 per share. This option price was higher than the estimated fair market value of the company's shares at the time the options were granted in January, 2019.

   On July 15, 2019, Alexa exercised these options. At this time the fair market value of the shares was $48 per share. Alexa immediately sold the shares for $48 per share.

4. One of the reasons Alexa has stayed with AAAA is the employer provided free day care facility located on AAAA's property. It is not open to the public. She has two sets of twins aged 2 and 4. She estimates that she would have to pay an annual minimum of $8,500 per child for day care without the facility.

5. AAAA offers all of its employees a 20 percent discount on full price merchandise in all of its stores. Alexa purchased $2,800 worth of merchandise during 2019 and received discounts totalling $560. The discounted price of this merchandise was greater than its cost to the Company.

6. AAAA provided Alexa with the following additional benefits:

| | |
|---|---|
| Takeout Meals Eaten While Working Infrequently Required Overtime | $1,200 |
| Private Health Care Plan - Employer Portion | 1,800 |
| Personal Fitness Trainer Fees In Company Wellness Centre | 700 |

7. Alexa was required by AAAA to use a large tablet to fulfill her employment duties. She was free to choose whatever tablet she wanted to use. AAAA would reimburse her for it and it would be company property. During 2019, she purchased:

   - an iPad Pro for $1,775 (GST inclusive)
   - a wireless printer for $450 (GST inclusive)
   - ink cartridges and paper totaling $550 (GST inclusive)

   The tablet and the printer were used exclusively for Company business.

**Required** Determine Alexa's net employment income for the year ending December 31, 2019. Show all calculations.

## Assignment Problem Three - 11

### (Commission Income And Work Space In Home)

Jerald Gilreath is an employee of a Canadian publicly traded company. He works in their Calgary office and lives downtown in a high-rise condominium. In addition to his 2019 base salary of $175,000, he earns commissions of $21,460.

Other employment related information is as follows:

1. Jerald's employer requires him to pay all of his employment related expenses, as well as provide his own office space. Jerald has the required Form T2200 from his employer.

2. Jerald's travel costs for 2019, largely airline tickets, food, and lodging, total $26,900. This includes $11,300 spent on meals while traveling for his employer. This meal total includes meals with clients of $4,300.

3. Jerald is a member of his employer's registered pension plan. During 2019, $4,100 was withheld from his salary as a contribution to this plan. His employer made a matching contribution of $4,100.

4. During 2019, Jerald pays dues to his professional association of $422.

5. During 2019, Jerald was billed a total of $10,500 by his golf club in Calgary. Of this amount, $2,850 was the annual membership fee, with the remaining amount for meals and drinks with clients. He uses the club only when he is with clients.

6. For his employment related travel, Jerald drives a car that he purchased on January 1, 2019 for $42,000, including GST. During 2019, he drives 52,000 kilometers, of which 43,000 are employment related. Jerald had financed the car with a loan from a local bank and, during 2019, he had paid interest of $2,750.

   The costs of operating the car during 2019 were $10,920. He has been advised by his accountant that, if the car were used 100 percent for employment related activities, the maximum CCA for 2019 would be $4,500.

7. Jerald uses 25 percent of his personal residence as an office. During 2019, the costs associated with his home were as follows:

| | |
|---|---:|
| Interest Payments On Mortgage | $ 9,100 |
| Property Taxes | 3,750 |
| Utilities | 1,925 |
| Insurance | 1,060 |
| Furnace, Wiring And Foundation Repairs | 4,200 |
| Total | $20,035 |

8. At the beginning of 2019, Jerald's employer grants him options to buy 500 of the Company's shares at a price of $17.50 per share. This was the market price of the shares at the time the options were granted. During July, 2019, when the shares are trading at $19.75 per share, he exercises all of these options. In order to buy Christmas gifts for his family, he sells 100 of these shares in early December, 2019. The proceeds are $20.50 per share.

9. His employer has a policy of giving all employees gifts to promote employee loyalty and help local businesses. During 2019, Jerald received the following gifts:
   - A weekend for him and his wife at a local hotel. The value of this gift was $425.
   - A $400 gift certificate at a local electronics/hardware store.
   - A basket of fruit, nuts, and cheeses, with a value of $225.

10. During 2019, Jerald purchased tickets to Calgary Flames games for $1,920. He used these tickets to attend the games with key personnel from important clients. He also purchased tickets to a Montreal Canadiens game in Montreal for $864. He used these tickets to attend the game with a prospective client located in Montreal.

**Required:** Calculate Jerald's minimum net employment income for the 2019 taxation year. Ignore GST and PST considerations.

### *Assignment Problem Three - 12*

#### *(Employment Income - No Commissions)*

Mr. Jason Bond has been employed for many years as a graphic illustrator in Kamloops, British Columbia. His employer is a large publicly traded Canadian company. During 2019, his gross salary was $82,500. In addition, he was awarded a $20,000 bonus to reflect his outstanding performance during the year. As he was in no immediate need of additional income, he arranged with his employer that none of this bonus would be paid until 2024, the year of his expected retirement.

**Other Information**:
For the 2019 taxation year, the following items were relevant.

1. Mr. Bond's employer withheld the following amounts from his income:

| | |
|---|---|
| Federal Income Tax | $16,000 |
| Employment Insurance Premiums | 860 |
| Canada Pension Plan Contributions | 2,749 |
| United Way Donations | 2,000 |
| Registered Pension Plan Contributions | 3,200 |
| Payments For Personal Use Of Company Car | 3,600 |

2. During the year, Mr. Bond was provided with an automobile owned by his employer. The cost of the automobile was $47,500. Mr. Bond drove the car a total of 10,000 kilometers during the year, of which only 4,000 kilometers were related to the business of his employer. The automobile was used by Mr. Bond for ten months of the year. During the other two months, he was out of the country, and he was required to return the automobile to the company.
3. During the year, the corporation paid Mega Financial Planners a total of $1,500 for providing counseling services to Mr. Bond with respect to his personal financial situation.
4. In order to assist Mr. Bond in purchasing a ski chalet, the corporation provided him with a five year loan of $150,000. The loan was granted on October 1 at an interest rate of 1 percent. Mr. Bond paid the corporation a total of $375 in interest for 2019 on January 20, 2020. Assume that, at the time the loan was granted and throughout the remainder of the year, the relevant prescribed rate was 2 percent.
5. Mr. Bond was required to pay professional dues of $1,800 during the year.
6. On June 6, 2019, when Mr. Bond exercised his stock options to buy 1,000 shares of his employer's common stock at a price of $15 per share, the shares were trading at $18 per share. When the options were issued, the shares were trading at $12 per share. During December, 2019, the shares were sold for $20 per share.

**Required**: Calculate Mr. Bond's minimum net employment income for the year ending December 31, 2019. Provide reasons for omitting items that you have not included in your calculations. Ignore GST and PST considerations.

## *Assignment Problem Three - 13*

### *(Alternative Employment Offers)*

For several years, Alexandra Blanco has represented several companies as an independent sales representative. As she has been very effective for her clients, two of these companies, Mega Inc. and Tetra Ltd., are interested in hiring her as a full time employee. Both of the employment offers would require Alexandra to begin service as of January, 2019. However, the offers from the two corporations differ significantly in the form and content of their proposed compensation.

**MEGA INC. OFFER** The offer from Mega Inc. contains the following provisions:

- She would be paid a salary of $280,000 per year. No commissions would be paid on her sales.
- Mega will provide an allowance of $35,000 per year to cover hotel, meals while travelling, and airline costs. The employer believes that the CRA will consider this allowance to be reasonable in the circumstances.
- No allowance or reimbursement will be provided for advertising and promotion expenses.

- Mega will provide her with an automobile for 12 months of the year which they would purchase for $45,000. The employer will pay all of the operating costs for the automobile.
- Mega will provide Alexandra with a $250,000 interest free loan for a period of 5 years. Alexandra will be investing all of these funds in publicly traded securities.
- Mega will provide Alexandra with a group disability insurance plan for which the company will pay all of the premiums. The plan provides periodic benefits that compensate for lost employment income. This will cost Mega $4,500 per year.
- Mega will provide Alexandra with a $800,000 face value life insurance policy. All of the premiums, which will total $2,900 per year, will be paid by Mega.

**TETRA LTD. OFFER** The offer from Tetra Ltd. contains the following provisions:

- She would be paid a salary of $190,000, plus a commission on all of her sales. Alexandra estimates that these commissions will total $90,000 during 2019.
- Tetra will reimburse all of her hotel, meal while travelling, and airline costs.
- No allowance or reimbursement will be provided for advertising and promotion expenses.
- While Tetra will not provide Alexandra with an automobile, it will provide an allowance of $1,800 per month to use her own automobile for her employment activities. Alexandra bought her car last year for $30,000. She estimates that the total cost of using her automobile for both personal and employment activities during 2019 will be as follows:

| | |
|---|---:|
| Operating Costs | $16,800 |
| Capital Cost Allowance (Tax Depreciation) (100%) | 4,500 |
| Financing Costs | 2,200 |
| Total | $23,500 |

- Tetra will provide Alexandra with a group disability insurance plan for which the company will pay all of the premiums. The plan provides periodic benefits that compensate for lost employment income. This will cost Tetra $5,000 per year.
- Tetra will provide Alexandra with a $1,500,000 face value life insurance policy. All of the premiums, which will total $4,200 per year, will be paid by Tetra.

**Other Information**

The following information is applicable to either of the alternative offers.

1. Alexandra estimates that her employment related expenses during 2019 would be as follows:

| | |
|---|---:|
| Travel Costs (Hotel And Airline Costs) | $24,000 |
| Travel Costs (Meals) | 10,500 |
| Advertising And Promotion | 26,000 |

2. Whether it is the employer's automobile or her own personal vehicle, she would use the car throughout 2019. She expects to drive this vehicle a total of 48,000 kilometers during 2019, with 32,000 of these kilometers required by her employment activities.
3. Assume that the prescribed rate is 2 percent throughout 2019.

**Required:**

A. Based on the estimates made by Alexandra, calculate Alexandra's minimum 2019 net employment income for each of the two offers. Ignore PST and GST considerations.

B. Discuss the factors that Alexandra should consider in deciding between the two alternatives.

### Assignment Problem Three - 14

#### (Employment Income)

For the past 5 years, Mr. Brooks has been employed as a financial analyst by a large Canadian public firm located in Winnipeg. During 2019, his basic gross salary amounts to $63,000. In addition, he was awarded an $11,000 bonus based on the performance of his division. Of the total bonus, $6,500 was paid in 2019 and the remainder is to be paid on January 15, 2019.

During 2019, Mr. Brooks' employer withheld the following amounts from his gross wages:

| | |
|---|---|
| Federal Income Tax | $3,000 |
| Employment Insurance Premiums | 860 |
| Canada Pension Plan Contributions | 2,749 |
| Registered Pension Plan Contributions | 2,800 |
| Donations To The United Way | 480 |
| Union Dues | 240 |
| Payments For Personal Use Of Company Car | 1,000 |

**Other Information**:

1. Due to an airplane accident while flying back from Thunder Bay on business, Mr. Brooks was seriously injured and confined to a hospital for two full months during 2019. As his employer provides complete group disability insurance coverage, he received a total of $4,200 in payments during this period. All of the premiums for this insurance plan are paid by the employer. The plan provides periodic benefits that compensate for lost employment income.

2. Mr. Brooks is provided with a car that the company leases at a rate of $678 per month, including both GST and PST. The company pays for all of the operating costs of the car and these amounted to $3,500 during 2019. Mr. Brooks drove the car a total of 35,000 kilometers during 2019, 30,000 kilometers of which were carefully documented as employment related travel. While he was in the hospital (see Item 1), his employer required that the car be returned to company premises.

3. On January 15, 2018, Mr. Brooks received options to buy 200 shares of his employer's common stock at a price of $23 per share. At this time, the shares were trading at $20 per share. Mr. Brooks exercised these options on July 6, 2019, when the shares were trading at $28 per share. He does not plan to sell the shares for at least a year.

4. In order to assist Mr. Brooks in acquiring a new personal residence in Winnipeg, his employer granted him a five year, interest free loan of $125,000. The loan qualifies as a home relocation loan. The loan was granted on October 1, 2019 and, at this point in time, the interest rate on open five year mortgages was 5 percent. Assume the relevant ITR 4301 rate was 2 percent on this date. Mr. Brooks purchases a house for $235,000 on October 2, 2019. He has not owned a home during any of the preceding four years.

5. Other disbursements made by Mr. Brooks include the following:

   | | |
   |---|---|
   | Advanced financial accounting course tuition fees | $1,200 |
   | Music history course tuition fees (University of Manitoba one week intensive course) | 600 |
   | Fees paid to financial planner | 300 |
   | Payment of premiums on life insurance | 642 |

   Mr. Brooks' employer reimbursed him for the tuition fees for the accounting course, but not the music course.

**Required:** Calculate Mr. Brooks' net employment income for the taxation year ending December 31, 2019.

# CHAPTER 4

# Taxable Income And Tax Payable For Individuals

## Introduction

4-1. As discussed in Chapter 1, Taxable Income is Net Income For Tax Purposes, less a group of deductions that are specified in Division C of Part I of the *Income Tax Act*. Also noted in the Chapter 1 material was the fact that Net Income For Tax Purposes is made up of several different income components. These components are employment income, business and property income, taxable capital gains, other sources, and other deductions.

4-2. Some tax texts defer any coverage of Taxable Income and Tax Payable until all of the income components that make up Net Income For Tax Purposes have been given detailed consideration. Despite the fact that the only component of Taxable Income that we have covered to this point is employment income, we decided to introduce material on Taxable Income and Tax Payable for individuals at this point in the text.

**Major Reason** The major reason for this approach is that it allows us to introduce the many tax credits that go into the calculation of Tax Payable at an earlier stage in the text. We believe that this enhances the presentation of the material in subsequent Chapters on business income, property income, and taxable capital gains. For example, in our discussion of property income, we can deal with after tax rates of return, as well as provide a meaningful discussion of the economics of the dividend gross up/tax credit procedures.

**Other Reasons** Other reasons for this organization of the material are more pedagogical in nature.

- Leaving the coverage of tax credits until after the completion of the material on all of the components of Taxable Income places this complex subject in the last weeks of most one semester tax courses. This can create significant difficulties for students.
- By introducing Taxable Income and Tax Payable at this earlier stage in the text, instructors who wish to do so can make more extensive use of the tax software program and problems provided with the text.

4-3. Since a significant portion of the material on Taxable Income and Tax Payable can be best understood after covering the other types of income that make up Net Income For Tax

Purposes, we require a second Chapter dealing with the subject of Taxable Income and Tax Payable. In addition, a few of the credits that are available in the calculation of Tax Payable require an understanding of additional aspects of business income, property income, and taxable capital gains. Given this, Chapter 11 is devoted to completing the necessary coverage of Taxable Income and Tax Payable for individuals. The determination of Taxable Income and Tax Payable for corporations is covered in Chapters 12 and 13. The determination of Taxable Income and Tax Payable for partnerships is covered in Chapter 18 and the determination of Taxable Income and Tax Payable for trusts is covered in Chapter 19.

# Taxable Income Of Individuals

## Available Deductions

4-4. The deductions that are available in calculating the Taxable Income of an individual can be found in Division C of Part I of the *Income Tax Act*. As indicated in the introduction to this Chapter, some of these deductions will be dealt with in this Chapter. However, coverage of the more complex items is deferred until Chapter 11. The available deductions, along with a description of their coverage in this text, are as follows:

**ITA 110(1)(d), (d.01), and (d.1) - Employee Stock Options** Our basic coverage of stock options and stock option deductions is included in Chapter 3. This coverage will not be repeated here.

**ITA 110(1)(f) - Deductions For Payments** This deduction, which is available for social assistance and workers' compensation received, is covered beginning in Paragraph 4-6.

**ITA 110.2 - Lump Sum Payments** ITA 110.2 provides a deduction for certain lump-sum payments (e.g., an amount received as a court-ordered termination benefit and included in employment income). It provides the basis for taxing this amount as though it were received over several taxation years (i.e., income averaging). Because of its limited applicability, no additional coverage is given to this provision.

**ITA 110.6 - Lifetime Capital Gains Deduction** The provisions related to this deduction are very complex and require a fairly complete understanding of capital gains. As a consequence, this deduction is covered in Chapter 11.

**ITA 110.7 - Residing In Prescribed Zone (Northern Residents Deductions)** These deductions, which are available only to individuals living in prescribed regions of northern Canada, are given limited coverage in Paragraph 4-9.

**ITA 111 - Losses Deductible** This is a group of deductions that is available for carrying forward or carrying back various types of losses. The application of these provisions can be complex and requires a fairly complete understanding of business income, property income, and capital gains. Coverage of this material for individuals is deferred until Chapter 11. Coverage of corporate loss carry overs is found in Chapter 12.

## Ordering Of Deductions

4-5. ITA 111.1 specifies, to some degree, the order in which individuals must subtract the various deductions that may be available in the calculation of Taxable Income. As our coverage of these deductions is not complete in this Chapter, we will defer coverage of this ordering provision until Chapter 11.

## Deductions For Payments - ITA 110(1)(f)

4-6. ITA 110(1)(f) provides for the deduction of certain amounts that have been included in the calculation of Net Income For Tax Purposes. The items listed here are:

- amounts that are exempt from tax in Canada by virtue of a provision in a tax treaty or agreement with another country;

- workers' compensation payments received as a result of injury or death;
- income from employment with a prescribed international organization; and
- social assistance payments made on the basis of a means, needs, or income test and included in the taxpayer's income.

4-7. At first glance, this seems to be a fairly inefficient way of not taxing these items. For example, if the government does not intend to tax social assistance payments, why go to the trouble of including them in Net Income For Tax Purposes, then deducting an equivalent amount in the calculation of Taxable Income?

4-8. There is, however, a reason for this. There are a number of items that influence an individual's tax obligation that are altered on the basis of the individual's Net Income For Tax Purposes. For example, we will find later in this Chapter that the amount of the age tax credit is reduced by the individual's Net Income For Tax Purposes in excess of a specified amount (a.k.a., the threshold amount or the income threshold). In order to ensure that income tests of this type are applied on an equitable basis, amounts are included in Net Income For Tax Purposes, even in situations where the ultimate intent is not to assess tax on these amounts.

### Northern Residents Deductions - ITA 110.7

4-9. Residents of Labrador, the Territories, as well as parts of some of the provinces, are eligible for deductions under ITA 110.7. To qualify for these deductions, the taxpayer must be resident in these prescribed regions for a continuous period of six months beginning or ending in the taxation year. The amount of the deductions involves fairly complex calculations that go beyond the scope of this text. The purpose of these deductions is to compensate individuals for the high costs that are associated with living in such prescribed northern zones.

## Calculation Of Tax Payable

### Federal Tax Payable Before Credits

4-10. The calculation of federal Tax Payable for individuals requires the application of a group of progressive rates to marginal increments in Taxable Income. The rates are progressive, starting at a low rate of 15 percent and increasing to a high of 33 percent as the individual's Taxable Income increases. In order to maintain fairness, the brackets (i.e., income segments) to which these rates apply are indexed to reflect changes in the Consumer Price Index. Without such indexation, taxpayers could find themselves effectively subject to higher rates without having an increased level of real, inflation adjusted income.

4-11. For 2019, the brackets to which these five rates apply are as follows:

| Taxable Income In Excess Of | Federal Tax | Marginal Rate On Excess |
|---|---|---|
| $ -0- | $ -0- | 15.0% |
| 47,630 | 7,145 | 20.5% |
| 95,259 | 16,908 | 26.0% |
| 147,667 | 30,535 | 29.0% |
| 210,371 | 48,719 | 33.0% |

4-12. Note that the average rate for an individual just entering the 20.5 percent bracket is 15 percent ($7,145 ÷ $47,630). For an individual just entering the highest 33 percent bracket, the average rate is 23.2 percent ($48,719 ÷ $210,371).

4-13. There is a common misconception that once Taxable Income reaches the next tax bracket, all income is taxed at a higher rate. This is not the case as each rate is a marginal rate. For example, if Taxable Income is $210,372 ($210,371 + $1), only $1 is taxed at 33 percent.

4-14. The preceding table suggests that individuals are taxed on their first dollar of income. While the 15 percent rate is, in fact, applied to all of the first $47,630 of Taxable Income, a portion of this amount is not really subject to taxes. As will be discussed later in this Chapter,

every individual resident in Canada is entitled to a personal tax credit. For 2019, this tax credit is $1,810 [(15%)($12,069)]. In effect, this means that no taxes will be paid on at least the first $12,069 of an individual's Taxable Income. The amount that could be earned tax free would be even higher for individuals with additional tax credits (e.g., the age credit).

4-15. As an example of the calculation of federal Tax Payable before credits and the resulting average rate of taxation, consider an individual with Taxable Income of $98,300. The calculation would be as follows:

| | |
|---|---|
| Tax On First $95,259 | $16,908 |
| Tax On Next $3,041 ($98,300 - $95,259) At 26% | 791 |
| Federal Tax Payable Before Credits | $17,699 |
| | |
| Average Rate Of Tax ($17,699 ÷ $98,300) | 18% |

4-16. A surtax is an additional tax calculated on the basis of the regular Tax Payable calculation. While such additional taxes are not assessed at the federal level, during 2017, they were used in two provinces, Ontario and Prince Edward Island. In the March, 2018 Ontario budget, the Liberal government (under Kathleen Wynne) proposed that the old surtaxes be built into the regular rates. The Liberals lost the June, 2018 Ontario election. As a result of a Conservative majority, the outcome of the 2018 Ontario budget proposals is very uncertain.

## Provincial Tax Payable Before Credits

### *Provincial Rates*

4-17. As is the case at the federal level, provincial Tax Payable is calculated by multiplying Taxable Income by a group of progressive rates. In general, the provinces other than Quebec use the same Taxable Income figure that is used at the federal level.

4-18. Prior to 2016, Alberta was unique in that it used a single flat rate of 10 percent applied to all levels of income. However, Alberta joined the progressive rates club in 2016. All provinces use anywhere from 3 to 6 different tax rates applied to various levels of income. In general, the applicable income levels differ from those used in the federal brackets.

4-19. To give you some idea of the range of provincial rates, the 2019 minimum and maximum rates for provinces other than Quebec are found in the following table. The maximum rates include surtaxes where applicable. These rates are correct as of January 1, 2019. You may see other rates after this point in time as provincial budgets are introduced.

| **As Of January 1, 2019 Province** | **Minimum 2019 Tax Rate** | **Maximum 2019 Tax Rate** |
|---|---|---|
| Alberta | 10.00% | 15.00% |
| British Columbia | 5.06% | 16.80% |
| Manitoba | 10.80% | 17.40% |
| New Brunswick | 9.68% | 20.30% |
| Newfoundland and Labrador | 8.70% | 18.30% |
| Nova Scotia | 8.79% | 21.00% |
| Ontario (Maximum Includes 56% Surtax On Tax Payable) | 5.05% | 20.53% |
| Prince Edward Island (Maximum Includes 10% Surtax On Tax Payable) | 9.80% | 18.37% |
| Saskatchewan | 10.50% | 14.50% |

4-20. You should note the significant differences in rates between the provinces. The maximum rate ranges from 14.5 percent in Saskatchewan to 21 percent in Nova Scotia. This difference amounts to extra provincial taxes of $6,500 per year on each additional $100,000 of income. This can make provincial tax differences a major consideration when an individual decides where he should establish provincial residency.

4-21. When these provincial rates are combined with the federal rate schedule, the minimum combined rate varies from a low of 20.05 percent in Ontario (15 percent federal, plus 5.05 percent provincial), to a high of 25.8 percent in Manitoba (15 percent federal, plus 10.8 percent provincial).

4-22. Maximum combined rates are lowest in Saskatchewan where the rate is 47.5 percent (33 percent federal, plus 14.5 percent provincial). They are highest in Nova Scotia where the combined rate is 54 percent (33 percent federal, plus 21 percent provincial). Because the calculations are completely different, we have not included Quebec in this list of rates. We would note however, the overall rate in Quebec ranges from a low of 27.53 percent to a high of 53.31 percent.

## Exercise Four - 1

**Subject:** Calculation Of Tax Payable Before Credits

During 2019, Joan Matel is a resident of Ontario and has calculated her Taxable Income to be $56,700. Assume that Ontario's rates are 5.05 percent on Taxable Income up to $47,630 and 9.15 percent on the next $47,629. Calculate her 2019 federal and provincial Tax Payable before consideration of credits, and her average rate of tax.

**SOLUTION available in print and online Study Guide.**

### *Provincial Residence*

4-23. Given the significant differences in provincial tax rates on individuals, it is somewhat surprising that the rules related to where an individual will pay provincial taxes are fairly simple. With respect to an individual's income other than business income, it is subject to tax in the province in which he resides on the last day of the taxation year. This means that, if an individual moves to Ontario from Nova Scotia on December 30 of the current year, any income for the entire year, other than business income, will be taxed in Ontario.

## Types Of Income

4-24. In terms of the effective tax rates, the income accruing to Canadian individuals can be divided into three basic categories:

**Ordinary Income** This would include employment income, business income, property income other than dividends, and other sources of income. In general, the effective tax rates on this category are those presented in the preceding tables. For example, the marginal rate for an individual living in Alberta and earning more than $350,000, would be 48 percent (33 percent federal, plus 15 percent provincial).

**Capital Gains** As will be discussed in detail in Chapter 8, capital gains arise on the disposition of capital property. Only one-half of such gains are included in Net Income For Tax Purposes and Taxable Income. This means that the effective tax rate on this category of income is only one-half of the rates presented in the preceding tables. Returning to our Alberta resident who is earning more than $350,000, his effective marginal rate on capital gains would be 24 percent [(1/2)(33% + 15%)].

**Dividends** As will be explained in Chapter 7, dividends from taxable Canadian companies are subject to a gross up and tax credit procedure which reduces the effective tax rate on this type of income. Also in that Chapter, we explain the difference between eligible dividends and non-eligible dividends. Continuing with our Alberta example, maximum federal/provincial tax rates on dividends are as follows:

| | |
|---|---|
| Eligible Dividends | 31.71% |
| Non-Eligible Dividends | 42.56% |

4-25. A more complete discussion of the different effective tax rates mentioned here is provided in Chapter 7 (dividends) and Chapter 8 (capital gains).

### Taxes On Income Not Earned In A Province

4-26. As will be discussed in Chapter 20, International Issues In Taxation, it is possible for an individual to be considered a resident of Canada for tax purposes, without being a resident of a particular province or territory. This would be the case, for example, for members of the Canadian Armed Forces who are stationed outside of Canada.

4-27. Income that is not subject to provincial or territorial tax is subject to additional taxation at the federal level. This additional tax is a surtax of 48 percent on federal tax payable. This gives a maximum rate of 48.84 percent [(33%)(148%)]. This additional tax is paid to the federal government.

## Calculating Tax Credits

### Federal Amounts

4-28. The most direct way of applying a tax credit system is to simply specify the amount of each tax credit available. In 2019, for example, the basic personal tax credit could have been specified to be $1,810. However, the Canadian tax system is based on a less direct approach. For most credits, but not all credits, a base amount is provided, to which the minimum federal tax rate (currently 15 percent) is applied. This means that, for 2019, the basic personal tax credit is calculated by taking 15 percent of $12,069 (we will refer to this number as the tax credit base), resulting in a credit against Tax Payable in the amount of $1,810.

4-29. In our tax credit calculations, we will sum the tax credit bases for which the 15 percent rate is used, then apply 15 percent to the total. This approach, rather than applying 15 percent to each credit base, makes relationships between the various credit bases easier to see and reduces calculation errors. We strongly suggest you use this approach in solving problems and writing examinations.

4-30. As was the case with the tax rate brackets, in order to avoid having these credits decline in value in terms of real dollars, the base for the tax credits needs to be adjusted for changing prices.

4-31. A technical problem in calculating credits will arise in the year a person becomes a Canadian resident, or ceases to be a Canadian resident. As discussed in Chapter 20, such individuals will only be subject to Canadian taxation for a part of the year. Given this, it would not be appropriate for them to receive the same credits as an individual who is subject to Canadian taxation for the full year. This view is reflected in ITA 118.91, which requires a pro rata calculation for personal tax credits, the disability tax credit and tax credits transferred from a spouse or a person supported by the taxpayer. Other tax credits, for example the tax credits for charitable donations and adoption expenses, are not reduced because of part year residence. This is because these credits reflect actual amounts paid or costs incurred during the period of Canadian residency.

### Provincial Amounts

4-32. In determining provincial tax credits, the provinces use the same approach as that used at the federal level. That is, the minimum provincial rate is applied to a base that is indexed each year. In most cases, the base used is different from the base used at the federal level. For 2019, the basic personal tax credit at the federal level is $1,810 [(15%)($12,069)]. Comparative 2019 figures for selected provinces are as follows:

| Province | Base | Rate | Credit |
|---|---:|---:|---:|
| Alberta | $19,369 | 10.00% | $1,937 |
| British Columbia | 10,682 | 5.06% | 541 |
| Newfoundland And Labrador | 9,414 | 8.70% | 819 |
| Ontario | 10,582 | 5.05% | 534 |

# Personal Tax Credits - ITA 118(1)

## Individuals With A Spouse Or Common-Law Partner - ITA 118(1)(a)

### Basic Personal Credit Plus Spousal Credit

4-33. For individuals with a spouse or common-law partner, ITA 118(1)(a) provides for two tax credits — one for the individual (sometimes referred to as the basic personal credit which is the term we use in our material) and one for his or her spouse or common-law partner. This latter credit is sometimes referred to as the spousal credit which is the term we use in our material. The spousal credit is applicable to common-law partners, but to include that in the title would be awkward. For 2019, the **basic personal credit is $1,810** [(15%)($12,069)].

### Calculation Of Spousal Credit

4-34. If the individual's spouse is not dependent because of a mental or physical infirmity, the spousal credit is calculated using the same base as the basic personal credit. However, it must be reduced by the spouse or common-law partner's Net Income For Tax Purposes.

4-35. In those cases where the spouse or common-law partner is dependent on the individual by reason of a mental or physical infirmity, ITA 118(1)(a) adds, for 2019, an additional $2,230. We will discuss in detail the meaning of mental or physical infirmity beginning in Paragraph 4-53 within our coverage of the Canada caregiver credit.

4-36. The two possible calculations of the spousal credit are as follows:

**Spousal Credit - Spouse Is Not Infirm**
[(15%)($12,069 - Spouse Or Common-Law Partner's Net Income)]

**Spousal Credit - Spouse Is Mentally Or Physically Infirm**
[(15%)($12,069 + $2,230 - Spouse Or Common-Law Partner's Net Income)]
When the spouse is mentally or physically infirm, the maximum value for the credit is [(15%)($14,299)].

4-37. As an example, consider an individual with a spouse who had Net Income For Tax Purposes of $5,200. The total personal credits under ITA 118(1)(a) if the spouse (1) was not mentally or physically infirm and (2) was dependent because of a mental or physical infirmity:

| Spouse | Not Infirm | Infirm |
|---|---|---|
| Basic Personal Amount (For Taxpayer) | $12,069 | $ 12,069 |
| Spousal Amount ($12,069 - $5,200) | 6,869 | |
| Spousal Amount ($12,069 + $2,230 - $5,200) | | 9,099 |
| Credit Base | $18,938 | $21,168 |
| Rate | 15% | 15% |
| Personal Tax Credits (Taxpayer And Spouse) | $ 2,841 | $ 3,175 |

4-38. There are several other points to be made with respect to the credits for an individual with a spouse or common-law partner:

**Spouse Or Common-Law Partner's Income** The income figure used for limiting the spousal amount is Net Income For Tax Purposes.

**Applicability To Either Spouse Or Common-Law Partner** The ITA 118(1)(a) provision is applicable to both spouses and, while each is eligible to claim the basic amount of $12,069, IT Folio S1-F4-C2, *Basic Personal and Dependant Tax Credits*, specifies that only one spouse or common-law partner may claim the spousal amount. S1-F4-C2 indicates that the spouse making the claim should be the one that supports the other. (Support is described in S1-F4-C2 Paragraph 2.18.)

**Eligibility** The spousal credit can be claimed for either a spouse or a common-law partner. There is no definition of spouse in the *Income Tax Act*, so it would appear that the usual dictionary definition would apply. That is, a spouse is one of a pair of persons who are legally married. With respect to common-law partner, ITA 248(1) defines such an individual as a person who cohabits with the taxpayer in a conjugal relationship and:

- has so cohabited for a continuous period of at least one year; or
- is the parent of a child of whom the taxpayer is also a parent.

There is no requirement in the income tax legislation that either a spouse or a common-law partner be a person of the opposite sex. One can, however, assume that they must be of the same species (e.g., you can't claim your dog, no matter how much he is dependent on you).

**Multiple Relationships** Based on these definitions, it would be possible for an individual to have both a spouse and a common-law partner. ITA 118(4)(a) makes it clear that, if this is the case, a credit can only be claimed for one of these individuals. In such cases, determining your tax credits may be the least of your problems.

**Year Of Separation Or Divorce** In general, ITA 118(5) does not allow a tax credit based on the spousal amount in situations where the individual is making a deduction for the support of a spouse or common-law partner (spousal support is covered in Chapter 9). However, S1-F4-C2 indicates that, in the year of separation or divorce, an individual can choose to deduct amounts paid for spousal support, or claim the tax credit for a spouse, but not both.

**Exercise Four - 2**

**Subject:** Spousal Tax Credit

Johan Sprinkle is married and has 2019 Net Income For Tax Purposes of $35,450. His spouse has 2019 Net Income For Tax Purposes of $2,600. Johan has no tax credits other than the basic personal credits for his spouse and himself. Assuming that Johan's spouse does not have a mental or physical infirmity, determine Johan's federal tax credits for 2019. How would your answer differ if Johan's spouse was dependent because of a mental or physical infirmity?

**SOLUTION available in print and online Study Guide.**

**We suggest you work Self Study Problem Four-1 at this point.**

## Individuals Supporting A Dependent Person - ITA 118(1)(b)

### Basic Personal Credit Plus Eligible Dependant Credit

4-39. Like ITA 118(1)(a), ITA 118(1)(b) provides for two tax credits. The first is the basic personal credit for the individual based on a 2019 base amount of $12,069. The second credit, based on the same amount, is for a qualifying eligible dependant. With respect to this second credit, if the eligible dependant is physically or mentally impaired, an additional amount of $2,230 is added to the $12,069. Note that this credit is not available to married individuals. We will discuss in detail the meaning of mental or physical infirmity beginning in Paragraph 4-53 within our coverage of the Canada caregiver credit.

### Eligibility And Eligible Dependant Defined

4-40. The eligible dependant credit is available to a single individual who is not claiming the spousal credit and who supports a wholly dependent person who lives with them in a self-contained domestic establishment (we will refer to this person as an eligible dependant). To qualify for this credit, the individual taxpayer must be:

- unmarried;
- not living in a common-law partnership; or
- a person who is married or has a common-law partner but neither supports nor lives with that spouse or common-law partner.

4-41. To claim this credit, the eligible dependant must be "related" to the individual making the claim and "wholly dependent for support". ITA 251(2) defines related individuals as those who are related by blood, marriage, common-law partnership, or adoption. IT Folio S1-F5-C1, *Related Persons And Dealing At Arm's Length*, indicates that this would exclude aunts, uncles, nieces, nephews, and cousins. To be wholly dependent would mean that the taxpayer provides almost entirely for the person's well-being. This means providing the necessities such as food, shelter and clothing, as well as all financial support. For example, a young child would normally be wholly dependent on a parent. Also note that the death of a spouse or common-law partner severs all marriage and common-law relationships. For example, an individual is not related to his deceased wife's mother.

4-42. In view of today's less stable family arrangements, the question of exactly who is considered a child for tax purposes requires some elaboration. The credit may be taken for natural children, children who have been formally adopted, as well as for natural and adopted children of a spouse or common-law partner.

### Application

4-43. This credit is most commonly claimed by single parents who are supporting a minor child. More generally, this credit is available to individual taxpayers who are single, widowed, divorced, or separated, and supporting a dependant who is:

- related to the individual by blood, marriage, adoption or common-law relationship;
- wholly dependent on the individual for support;
- under 18 at any time during the year, or mentally or physically infirm, or the individual's parent or grandparent;
- living with the individual in a home that the individual maintains (this would not disqualify a child who moves away during the school year to attend an educational institution as long as the home remains the child's home); and
- residing in Canada (this requirement is not applicable to an individual's child as long as they are living with the individual).

4-44. The eligible dependant credit cannot be claimed by an individual:

- if the individual is claiming the spousal credit;
- if the individual is living with, supporting, or being supported by a spouse (the claim is only available for individuals who are either single, or living separately from their spouse);
- for more than one person;
- if the dependant's Net Income exceeds \$12,069 or \$14,299 (\$12,069 + \$2,230) if they are mentally or physically infirm;
- if someone other than the individual is making this claim for the same individual; or
- for the individual's child, if the individual is required to make child support payments to another individual, for that child. As is noted in Chapter 9, when child support is being paid, only the recipient of such payments can claim this tax credit.

### Calculation Of Eligible Dependant Tax Credit

4-45. As we have noted, the base for the eligible dependant credit is \$12,069, the same value that is used for the basic personal credit and the spousal credit. As was the case with the spousal credit, if the eligible dependant is dependent because of a mental or physical infirmity, an additional \$2,230 is added to the 2019 base, bringing the total to \$14,299. The amount of the base is reduced by the eligible dependant's Net Income For Tax Purposes for the year. As was the case with the spousal credit, the infirmity does not have to be severe enough to qualify for the disability tax credit. For 2019, the calculation of the eligible dependant credit is as follows:

**Eligible Dependant Credit - Is Not Infirm**
[(15%)($12,069 - Eligible Dependant's Net Income)]

**Eligible Dependant Credit - Is Infirm And Is Not Under 18**
[(15%)($12,069 + $2,230 - Eligible Dependant's Net Income)]

4-46. As an example, consider an unmarried person supporting a parent who has Net Income For Tax Purposes of $5,200. The total personal credits under ITA 118(1)(b) if the (1) was not mentally or physically infirm and (2) was dependent because of a mental or physical infirmity, would be calculated as follows:

| Eligible Dependant | Not Infirm | Infirm |
|---|---|---|
| Basic Personal Amount (For Taxpayer) | $12,069 | $ 12,069 |
| Eligible Dependant Amount ($12,069 - $5,200) | 6,869 | |
| Eligible Dependant Amount ($12,069 + $2,230 - $5,200) | | 9,099 |
| Credit Base | $18,938 | $21,168 |
| Rate | 15% | 15% |
| Personal Tax Credits (Taxpayer And Eligible Dependant) | $ 2,841 | $ 3,175 |

4-47. Note that this credit provides for the same total credits that would be available to an individual with a spouse who had Net Income For Tax Purposes of $5,200 (see Paragraph 4-37). For this reason, it was formerly referred to as the equivalent to spouse tax credit.

## Canada Caregiver Amount For Child - ITA 118(1)(b.1)

4-48. There is no general tax credit available for a child who is under 18 at the end of the taxation year. However, in those cases where an under 18 year old child has a mental or physical infirmity, ITA 118(1)(b.1) provides a credit based on a 2019 base amount of $2,230 which is not decreased by any income of the child. In those cases where this credit is claimed for an infirm child by a single person, who also claims the eligible dependant credit for the child, the $2,230 is not added to the $12,069 base amount for that credit. The $2,230 is treated as a separate credit. We will discuss in detail the meaning of mental or physical infirmity beginning in Paragraph 4-53 within our coverage of the Canada caregiver credit.

**EXAMPLE** Mr. and Mrs. Barton have a 13 year old child who has a physical infirmity. The child has Net Income For Tax Purposes of $1,000.

**ANALYSIS** Either Mr. Barton or Mrs. Barton can claim a credit against Tax Payable of $335 [(15%)($2,230)].

## Single Persons (Basic Personal Tax Credit) - ITA 118(1)(c)

4-49. Individuals living with a spouse, common-law partner or eligible dependant receive a credit for themselves and their spouse or common-law partner under ITA 118(1)(a), or themselves and their eligible dependant under ITA 118(1)(b). For individuals who do not have a spouse, common-law partner or eligible dependant, a basic personal tax credit is received under ITA 118(1)(c). For 2019, the credit is equal to $1,810 [(15%)($12,069)].

**EXAMPLE** Jason Broad is 35 years old, single, is not involved in a relationship with a common-law partner (although he has been known to fool around from time to time), and has no dependants.

**ANALYSIS** Jason can claim a credit against Tax Payable of $1,810 [(15%)($12,069)].

## Canada Caregiver Tax Credit - ITA 118(1)(d)

### Background

4-50. An important issue in Canada is the fact that many individuals are responsible for taking care of, and/or supporting some related individual because of that individual's mental or physical infirmity. For some time, the federal government has dealt with this problem by providing some amount of monetary relief through the use of tax credits.

4-51. Prior to 2017, this tax relief was provided through three separate tax credits:

- the family caregiver credit
- the caregiver credit
- the infirm dependant over 17 credit

4-52. The application of these credits proved to be very confusing to many taxpayers. Reflecting this, the 2017 budget repealed these credits and replaced them with a single Canada caregiver credit. The current approach produces the same results as were produced by the now repealed credits and is far easier for taxpayers to understand and implement.

### *Mental Or Physical Impairment/Infirmity*

4-53. In our presentation on the spousal and eligible dependant credits, we noted that an extra base amount is available when the spouse or eligible dependant is mentally or physically impaired. Mental or physical impairment is also an eligibility requirement for the Canada caregiver credit. Given this, it is important to have some understanding of this concept.

4-54. Later in this Chapter, we will discuss the disability tax credit. This fairly substantial credit is available to an individual having one or more severe and prolonged impairments in physical or mental functions. For example, the disability tax credit would be available to an individual who could not dress or feed herself.

4-55. It is clear that an individual who qualifies for the disability tax credit would also qualify for the Canada caregiver amount and for the extra base amount that can be added to the spousal and eligible dependant amounts. It is also clear that an individual with a less severe impairment could qualify for these amounts.

4-56. While there have been a number of court cases which have discussed the meaning of mental or physical impairment, no consistent definition has emerged. For our purposes in this material, the following description will be used:

> The term mental or physical infirmity is not defined in the *Income Tax Act* and, therefore, it should be applied using its ordinary meaning. In most dictionaries and infirmity is described as a physical or mental weakness or ailment. In terms of the application of the term infirmity in tax work, it does not refer to a temporary weakness or ailment. In addition, the infirmity must be such that it requires the person to be dependent on the individual for a considerable period of time.

### *Calculation Of The Canada Caregiver Credit*

4-57. The Canada caregiver credit has two parts. For 2019, the amounts are as follows:

> **Part 1** - An amount of $7,140 for infirm dependants who are over 17 and who are parents, grandparents, brothers, sisters, aunts, uncles, nieces, nephews, and children of the claimant or his spouse or common-law partner. Note that aunts, uncles, nieces and nephews are eligible for the Canada caregiver credit where they are excluded from being claimed for the eligible dependant credit.
>
> The amount is reduced on a dollar for dollar basis by the dependant's Net Income For Tax Purposes in excess of $16,766.
>
> **Part 2** - An amount of $2,230 for:
>
> - An infirm dependent spouse or common-law partner for whom the individual claims the spouse or common-law partner credit. (See Paragraph 4-35.)
> - An infirm dependant for whom the individual claims the eligible dependant credit. (See Paragraph 4-45.)
> - An infirm child who is under 18 at the end of the year. Any income of the child does not decrease the amount. (See Paragraph 4-48.)

4-58. In terms of the actual legislation, only the $7,140 amount is referred to in ITA 118(1)(d). The $2,230 amounts for a spouse or eligible dependant are included under ITA 118(1)(a) and 118(1)(b). In those provisions, the $2,230 amount is not referred to as a caregiver amount. (In our problem solutions we label the additional $2,230 the "infirm amount".) To prevent double counting for a spouse or an eligible dependant, ITA 118(4)(c) indicates that, if an individual is entitled to a credit for an infirm spouse or eligible dependant under ITA 118(1)(a) or ITA 118(1)(b), they cannot make any claim under ITA 118(1)(d).

4-59. Several other points are relevant here:

- Only one Canada caregiver credit will be available for each infirm dependant. If there is more than one caregiver, the credit must be shared.
- An individual will not be able to claim the Canada caregiver credit for a particular person if the individual is required to pay a support amount for that person to their former spouse or common law partner.
- There is no requirement that the infirm dependant live in the caregiver's home in order to claim the Canada caregiver credit.
- Except in the case of children or grandchildren, to qualify for the Canada caregiver credit, the infirm dependant must be a resident of Canada.

## Exercise Four - 3

**Subject**: Canada Caregiver Tax Credit

Joan Barton lives with her husband whose Net Income For Tax Purposes is $5,000. Two years ago her father and mother moved in with her. The father, who is 69 years old is still very active. However, her 67 year old mother is dependent because of a physical infirmity, but the infirmity is not severe enough to qualify for the disability tax credit. Her father's 2019 Net Income For Tax Purposes is $25,300. The corresponding amount for her mother is $21,400. Determine the amount of Joan's Canada caregiver tax credit, if any, for 2019.

## Exercise Four - 4

**Subject:** Infirm Spouse And Infirm Adult Child

Marcia Flood is married to Josh Flood. Josh has a mental infirmity. They have a 20 year old son who has a physical infirmity. Neither infirmity is severe enough to qualify for the disability tax credit. Josh has 2019 Net Income For Tax Purposes of $5,600. Their son has no 2019 income. Determine the amount of any 2019 tax credits that Marcia will have related to her spouse and son.

## Exercise Four - 5

**Subject:** Infirm Eligible Dependant Who Is A Child Under 18

Darcy Gates is a single father who takes care of his 9 year old daughter, Janice. Janice has a physical infirmity, but the infirmity is not severe enough to qualify for the disability tax credit. Janice has no 2019 income of her own. Determine the amount of any 2019 tax credits that Darcy will have related to his daughter.

**SOLUTIONS available in print and online Study Guide.**

### Canada Caregiver Credit - Additional Amount

4-60. There is a problem in those cases where the $2,230 amount is provided through either the spousal tax credit or the eligible dependant tax credit. The base for both of these credits is reduced, on a dollar-for-dollar basis, by the dependant's Net Income For Tax Purposes. While the Canada caregiver amount is not eroded until the dependant's Net Income For Tax Purposes is greater than $16,766, the spousal and eligible dependant credits would be completely eliminated once income reaches $14,299 ($12,069 + $2,230). In effect, this would result in the caregiver for an infirm spouse or an infirm eligible dependant getting no benefit from the Canada caregiver credit provisions.

4-61. Under ITA 118(1)(e), when an individual has an infirm spouse or infirm eligible dependant, they are entitled to an additional amount of credit base in those situations where their claim for the spousal or eligible dependant amount is less than the Canada caregiver amount. The additional amount is the amount that is required to increase the claimant's base amount up to equal the Canada caregiver amount. This makes the calculations sound more complicated than they really are, as illustrated in the following example.

**EXAMPLE** Mark Stucky has an infirm spouse. Assume her 2019 Net Income For Tax Purposes is (1) $15,000 and (2) $8,000.

**ANALYSIS - $15,000** The base for Mark's spousal credit would be nil ($12,069 + $2,230 - $15,000). Given this, the additional amount would be $7,140 ($7,140 - nil). When this additional amount is added to the base for the spousal credit of nil, the total is $7,140, the 2019 base for the Canada caregiver credit.

**ANALYSIS - $8,000** The base for Mark's spousal credit would $6,299 ($12,069 + $2,230 - $8,000). Given this, the additional amount would be $841 ($7,140 - $6,299). When this additional amount is added to the base for the spousal credit, the total is $7,140, the 2019 base for the Canada caregiver credit.

**Exercise Four - 6**

**Subject:** Canada Caregiver Tax Credit - Additional Amount

Sandy Hill is single and lives with her 63 year old mother, Ariel. Ariel has a physical infirmity, but the infirmity is not severe enough to qualify for the disability tax credit. Ariel has 2019 Net Income For Tax Purposes of $18,000. Determine the amount of any 2019 tax credits that Sandy will have related to her mother.

**SOLUTION available in print and online Study Guide.**

# Other Tax Credits For Individuals

## Age Tax Credit - ITA 118(2)

4-62. For individuals who attain the age of 65 prior to the end of the year, ITA 118(2) provides an additional tax credit of $1,124 [(15%)($7,494)]. However, the base for this credit is reduced by **15 percent** of the individual's Net Income For Tax Purposes in excess of $37,790. This means that, at an income level of $87,750 [($7,494 ÷ 15%) + $37,790], the reduction will be equal to $7,494 and the individual will not receive an age credit. Note that the reduction is only 15 percent of the income above the threshold, not a dollar for dollar reduction.

**EXAMPLE** A 67 year old individual has 2019 Net Income For Tax Purposes of $40,000.

**ANALYSIS** An age credit of $1,074 {[15%][$7,494 - (15%)($40,000 - $37,790)]} will be available to this individual.

4-63. As we shall see when we consider the transfer of credits to a spouse, if an individual does not have sufficient Tax Payable to use this credit, it can be transferred to a spouse.

**Exercise Four - 7**

**Subject:** Age Tax Credit

Joshua Smythe is 72 years old and has 2019 Net Income For Tax Purposes of $51,500. Determine Mr. Smythe's age credit for 2019.

**SOLUTION available in print and online Study Guide.**

## Pension Income Tax Credit - ITA 118(3)

### *General Rules*

4-64. The pension income credit is equal to 15 percent of the first $2,000 of eligible pension income. This results in a maximum value of $300 [(15%)($2,000)]. The base for this credit is not indexed for inflation and has been $2,000 since 2006.

4-65. The credit is only available with respect to "eligible pension income". Specifically excluded from this definition are:

- payments under the Old Age Security Act or Canada Pension Plan;
- payments under certain provincial pension plans;
- payments under salary deferral arrangements;
- payments under retirement compensation arrangements;
- payments under an employee benefit plan; and
- death benefits.

4-66. Like the age credit, if an individual does not have sufficient Tax Payable to use this credit, it can be transferred to a spouse.

### *Individuals 65 Or Over*

4-67. For an individual who has reached age 65 before the end of the year, this credit is available on "pension income" as defined in ITA 118(7). This includes payments that are:

- periodic (not lump sum) payments from a registered pension plan (RPP);
- an annuity payment out of a Registered Retirement Savings Plan (RRSP);
- a payment out of a Registered Retirement Income Fund (RRIF);
- an annuity payment from a Deferred Profit Sharing Plan (DPSP); and
- the interest component of other annuities.

### *Individuals Under 65*

4-68. For an individual who has not reached age 65 during the year, the credit is based on "qualified pension income", also defined in ITA 118(7). In general, this only includes the periodic payments from a registered pension plan. However, if the other types of pension income described in Paragraph 4-67 are received as a consequence of the death of a spouse or common-law partner, these amounts are also qualified, regardless of the age of the recipient.

## Canada Employment Tax Credit - ITA 118(10)

4-69. This credit is available to all individuals who have employment income. From a conceptual point of view, it is designed to provide limited recognition of the fact that there are costs associated with earning employment income. As only limited deductions are available against employment income, this would appear to be an appropriate form of relief.

4-70. For 2019, the amount of the credit is equal to 15 percent of the lesser of:

- $1,222; and
- the individual's Net Employment Income, calculated without the deduction of any employment related expenses.

4-71. For most employed individuals, this will produce a credit of $183 [(15%)($1,222)].

## Adoption Expenses Tax Credit - ITA 118.01

4-72. The adoption expenses tax credit is available to a taxpayer who adopts an "eligible child". As defined in ITA 118.01(1), an eligible child means a child who has not attained the age of 18 years at the time that an adoption order is issued or recognized by a government in Canada in respect of the adoption of that child. For 2019, the indexed base for this credit is up to $16,255 of eligible adoption expenses. This provides a maximum credit of $2,438.

4-73. The expenses can only be claimed in the year in which the adoption is finalized. The total amount of eligible expenses is reduced by any assistance that is received and not included in that taxpayer's income. Normally, if an employer reimburses any portion of an employee's adoption expenses, this amount will be treated as a taxable benefit. Given this, such amounts will not be deducted from the adoption expenses that form the basis for this credit as they will be taxed as employment income.

4-74. Eligible adoption expenses must be incurred during the "adoption period" (see next Paragraph) and, as defined in ITA 118.01(1), include:

(a) fees paid to an adoption agency licensed by a provincial government;
(b) court costs and legal and administrative expenses related to an adoption order in respect of that child;
(c) reasonable and necessary travel and living expenses of the child and the adoptive parents;
(d) document translation fees;
(e) mandatory fees paid to a foreign institution;
(f) mandatory expenses paid in respect of the immigration of the child; and
(g) any other reasonable expenses related to the adoption required by a provincial government or an adoption agency licensed by a provincial government.

4-75. An "adoption period" is also defined in ITA 118.01(1) as follows:

It begins at the earlier of:

- the time that an application is made for registration with a provincial ministry responsible for adoption (or with an adoption agency licensed by a provincial government); and
- the time, if any, that an application related to the adoption is made to a Canadian court; and

It ends at the later of:

- the time an adoption order is issued by, or recognized by, a government in Canada in respect of that child, and
- the time that the child first begins to reside permanently with the individual.

4-76. In the usual situation, a child will be adopted by a couple, either legally married or co-habiting on a common-law basis. The legislation points out that, while both parties are eligible for this credit, the $16,255 limit must be shared by the couple. The claim can be made by either party or split at their discretion.

## Exercise Four - 8

**Subject:** Adoption Expenses Tax Credit

Ary Kapit and his spouse have adopted an infant Chinese orphan. The adoption process began in June, 2018 when they applied to an adoption agency licensed by the provincial government. Later that year they traveled to China to discuss the adoption and view available children. The cost of this trip was $4,250. Their provincial government opens the adoption file on February 13, 2019, and the adoption order is issued on August 27, 2019. In September, the couple returns to China to pick up their new daughter. The happy family returns to Canada on September 18, 2019. The cost of this trip is $6,420.

Additional expenses paid during the first week of September, 2019 were $1,600 paid to the Chinese orphanage and $3,200 paid to a Canadian adoption agency. Legal fees incurred during the adoption period were $2,700. After arrival in Canada, an additional $2,500 in medical expenses were incurred for the child prior to the end of 2019. Mr. Kapit's employer has a policy of providing reimbursement for up to $5,000 in adoption expenses eligible for the adoption expenses tax credit. This amount is received in September, 2019 and will be considered a taxable benefit to Mr. Kapit. What is the maximum adoption expenses tax credit that can be claimed by the couple?

**SOLUTION available in print and online Study Guide.**

## Digital News Subscriptions Credit - ITA 118.02

4-77. The 2019 budget provides for a temporary (2020 through 2025) credit for digital subscriptions with a Qualifying Canadian Journalism Organization. The base for the credit is limited to $500 of the cost of such subscriptions. This provides for a maximum credit of $75 [(15%)($500)] starting in 2020.

4-78. A Qualifying Canadian Journalism Organization is defined as a corporation, partnership, or trust that is primarily engaged in the production of original news content. The news content must be of general interest or related to current events, and must not be focused on a specific topic, such as sports or the arts. In addition, the organization must employ two or more arm's length journalists in the production of its content.

## Home Accessibility Tax Credit - ITA 118.041

### *Described*

4-79. The government provides a non-refundable tax credit for renovations that will allow seniors and persons with disabilities to live more independently at home. The base for the credit is equal to the lesser of $10,000 and the amount of qualifying expenditures for the year. The means that the maximum credit is $1,500 [(15%)($10,000)]. It does not appear that the $10,000 limit will be indexed.

4-80. The credit is available to a **qualifying individual** or an **eligible individual** for **qualifying expenditures** on an **eligible dwelling**.

4-81. As is often the case with income tax legislation, this basic provision contains a number of technical terms (in **bold** in Paragraph 4-80) which require further explanation. These explanations follow.

### *Qualifying And Eligible Individuals*

4-82. A qualifying individual is an individual who is 65 years of age or older, or who is eligible to claim the disability tax credit.

4-83. An eligible individual is a qualifying individual's spouse or common-law partner, or an individual who has claimed, or could have claimed under certain conditions, the eligible dependant or Canada caregiver credit for the qualifying individual. It would normally be a relative who ordinarily inhabits the same dwelling as the qualifying individual.

### Eligible Dwelling

4-84. To begin, an eligible dwelling is a housing unit located in Canada. It must be owned by the qualifying individual or by an eligible individual. While it will usually be the principal residence of the individual, this is not a requirement. It can be a house, cottage or condominium, but it cannot be a rented dwelling.

4-85. If more than one individual is eligible to claim the credit in relation to the same eligible dwelling, the $10,000 limit applies to the total amount claimed for that dwelling in the year. If there is more than one qualifying individual for an eligible dwelling, the total qualifying expenses cannot exceed $10,000 for the dwelling. If the qualifying individual has more than one principal residence in a tax year, the $10,000 limit applies to the total cost of qualifying expenses for all residences, not for each residence.

### Qualifying Renovations And Expenditures

4-86. To be considered a qualifying expenditure in a qualifying renovation, the renovation or alteration must be made to allow the qualifying individual to gain access to, or to be more mobile or functional within the dwelling, or to reduce the risk of harm to the qualifying individual either when gaining access to the home or within the dwelling itself. The improvements must be of an enduring nature and be considered integral to the eligible dwelling. As a general rule, if the item purchased will not become a permanent part of the dwelling, it is not eligible.

4-87. Qualifying expenses can include materials, fixtures, labour or professional services. The credit will only apply to work performed and paid for and/or goods acquired in that particular tax year. Any expenses claimed for the home accessibility tax credit must be supported by receipts. This is expected to help the CRA battle the underground cash economy as receipts will be needed for qualifying labour in order to claim the credit.

4-88. Although the CRA website does not provide a list of qualifying expenditures, it does provide a list of some of the expenses that are not eligible for the credit such as outdoor maintenance services and electronic home entertainment devices. Some renovations that would clearly qualify would be wheelchair ramps or lifts, walk-in bathtubs and wheel-in showers.

4-89. Note that some expenditures would qualify for both this credit and the medical expense tax credit (see Paragraph 4-109). For example, the cost of installing a ramp for a qualifying individual who is in a wheelchair would be a qualifying expenditure for both credits. Interestingly, the legislation is clear that, in cases such as this, the expenditures can be used in determining the base for both of these credits. This, in effect, results in a double credit for the same expenditure.

## Exercise Four - 9

**Subject**: Home Accessibility Tax Credit

Della and Marcus Jacobs are married and they are both aged 68. They jointly own the house they live in. Because a recent automobile accident damaged his back, Marcus has limited mobility and has great difficulty climbing stairs. During 2019, they spent $8,500 installing a ramp to replace the steps to the front door and $2,000 for a snow removal contract as Marcus was no longer able to shovel the snow. What is the maximum home accessibility credit that can be claimed for the 2019 taxation year and who should claim it?

**SOLUTION available in print and online Study Guide.**

## First Time Home Buyer's Tax Credit - ITA 118.05

4-90. A tax credit is available for first-time home buyers who acquire a qualifying home in Canada. The credit is equal to 15 percent of the first $5,000 of the cost of a qualifying home, resulting in a maximum credit of $750. This amount is not indexed. To be eligible for the credit, the buyer must intend to occupy the home no later than one year after its acquisition.

4-91. An individual will be considered a first-time home buyer if neither the individual nor the individual's spouse or common-law partner, owned and lived in another home in the calendar year of the home purchase, or in any of the 4 preceding calendar years.

4-92. The credit may be claimed by the individual who acquires the home or by that individual's spouse or common-law partner. For the purpose of this credit, a home is considered to be acquired by an individual only if the individual's interest in the home is registered in accordance with the applicable land registration system.

## Volunteer Firefighters And Volunteer Search And Rescue Workers Tax Credits - ITA 118.06 And 118.07

4-93. A credit is made available for both volunteer firefighters and volunteer search and rescue workers. The required services are defined in the *Income Tax Act* as follows:

> **Volunteer Firefighters Services** In this Section 118.06 and in Section 118.07, "eligible volunteer firefighting services" means services provided by an individual in the individual's capacity as a volunteer firefighter to a fire department that consist primarily of responding to and being on call for firefighting and related emergency calls, attending meetings held by the fire department and participating in required training related to the prevention or suppression of fires, but does not include services provided to a particular fire department if the individual provides firefighting services to the department otherwise than as a volunteer.
>
> **Volunteer Search And Rescue Workers Services** means services, other than eligible volunteer firefighting services, provided by an individual in the individual's capacity as a volunteer to an eligible search and rescue organization that consist primarily of responding to and being on call for search and rescue and related emergency calls, attending meetings held by the organization and participating in required training related to search and rescue services, but does not include services provided to an organization if the individual provides search and rescue services to the organization otherwise than as a volunteer.

4-94. As you can see, except for the type of services rendered, the conditions of service for the two types of credits are very similar.

4-95. For either type of volunteer, if they perform at least 200 hours of volunteer services during a taxation year, they are eligible for the relevant credit. It would appear that the required 200 hours can be solely one type of volunteer service or, alternatively, a combination of both types of services. The base for the non-refundable credit is $3,000, resulting in a credit of $450 [(15%)($3,000)]. This amount is not indexed.

4-96. Other relevant considerations are as follows:

- An individual meeting the 200 hour requirement can take either credit. However, they cannot take both, regardless of the number of hours of volunteer services.
- Under ITA 81(4), there is an exemption from inclusion in Net Income For Tax Purposes for up to $1,000 in compensation received for these types of volunteer work. This exemption is not available to individuals who claim either of these tax credits. Stated alternatively, an individual cannot have both the exemption and the tax credits.

## Charitable Donations Tax Credit - ITA 118.1

### Extent Of Coverage In This Chapter

4-97. For tax purposes, donations, even in the form of cash, are segregated into categories, each with a different set of rules. Additional complications arise when non-cash donations are made. To be able to deal with gifts of depreciable capital property, a full understanding of capital gains and CCA procedures is required. Given these complications, a comprehensive treatment of charitable gifts is deferred until we revisit Taxable Income and Tax Payable in Chapter 11. However, there is limited coverage of charitable donations in this Chapter.

### Eligible Gifts

4-98. In our coverage of donations in this Chapter, we will deal only with gifts of cash or monetary assets. Donations of other types of property are covered in Chapter 11.

4-99. In this Chapter, our coverage will be limited to what is referred to in ITA 118.1 as total charitable gifts. These include amounts donated to entities such as:

- a registered charity;
- a registered Canadian amateur athletic association;
- registered news organizations (the provisions for making these organizations a registered donee were included in the 2019 budget but will not be effective until 2020);
- a Canadian municipality;
- the Canadian government;
- a university outside of Canada which normally enrolls Canadian students; and
- a charitable organization outside of Canada to which the Canadian government made a gift in the current or preceding taxation year. In addition, a provision exists that allows the federal government to provide a limited 24 month registration for foreign charities that are involved in relief and humanitarian aid, provided the activities are in the national interest of Canada.

### Limits On Amount Claimed

4-100. It is the policy of the government to limit the amount of charitable donations that are eligible for the tax credit to a portion of a taxpayer's Net Income For Tax Purposes. Note that, while corporations deduct their donations from Taxable Income as opposed to receiving a credit against Tax Payable, the limits on the amount of eligible donations are the same for corporations as they are for individuals.

4-101. The general limit on eligible amounts of charitable gifts is 75 percent of Net Income For Tax Purposes. For individuals, this limit is increased to 100 percent of Net Income For Tax Purposes in the year of death and the preceding year.

### Calculating The Donation Credit

4-102. All of the credits that we have discussed to this point apply the lowest federal bracket of 15 percent to some defined base. In contrast, this credit's calculation uses a combination of three possible rates - 15, 29 and 33 percent. This reflects the belief that if the credit was only at 15 percent, high income individuals would not have an adequate monetary incentive to make charitable donations.

4-103. The formula for calculating the credit is found in ITA 118(3). Stated in a somewhat more understandable fashion, it is as follows:

[(15%)(A)] + [(33%)(B)] + [(29%)(C)], where

**A** = The first $200 of eligible gifts.

**B** = The lesser of:
- The amount by which total eligible gifts exceed $200; and
- The amount, if any, by which the individual's Taxable Income for the year exceeds $210,371 (i.e., the amount of income taxed at 33 percent)

**C** = The amount, if any, by which the individual's total gifts exceed the sum of $200 plus the amount determined in B.

**Note** If the taxpayer's Taxable Income does not exceed $210,371, the lesser amount of component B will be nil. This means that none of the credit is based on the 33 percent rate as no income is taxed at that rate. In these situations, the credit calculation is simply 15 percent of the first $200 of eligible gifts, plus 29 percent of any eligible gifts in excess of $200.

4-104. The following example will serve to illustrate the application of this formula:

**EXAMPLE** For 2019, Doyle McLaughlin has Net Income For Tax Purposes of $620,000 and Taxable Income of $600,000. During the year, Doyle makes eligible gifts of $300,000.

**ANALYSIS** The maximum base for his charitable donations credit would be $465,000 [(75%)($620,000)]. Doyle's charitable donations tax credit would be calculated as follows (note that Taxable Income is used in the following calculation):

A = $200
B = The Lesser Of:
- $300,000 - $200 = $299,800
- $600,000 - $210,371 = $389,629 = the income taxed at 33 percent

C = Nil [$300,000 - ($200 + $299,800)]

The charitable donation credit would be equal to $98,964, calculated as [(15%)($200)] + [(33%)($299,800)] + [(29%)(Nil)]. As you would expect with Doyle's Taxable Income exceeding $210,371 by more than the amount of his eligible gifts, none of his credit is based on 29 percent.

## Exercise Four - 10

**Subject:** Charitable Donations Tax Credit

For 2019, Travis Hoffman has Net Income For Tax Purposes of $350,000 and Taxable Income of $325,000. During the year, he makes eligible charitable gifts of $225,000. Determine Mr. Hoffman's 2019 charitable donations tax credit.

**SOLUTION available in print and online Study Guide.**

4-105. For couples, the CRA's administrative practices permit either spouse or common-law partner to claim some or all of the donations made by the couple. If neither individual has income taxed at 33 percent, combining the donations is advantageous given the 15 percent rate on the first $200 of donations. It would also be advantageous if one individual has sufficiently low income that not all of the couple's donations can be claimed, or if only one individual has income that is taxed at 33 percent. If both individuals have income that will be taxed at 33 percent, but neither can claim all the donations at that rate, the analysis is more complicated as splitting the donations could result in a higher combined donations credit.

### Carry Forward Of Charitable Donations

4-106. With the limit set at 75 percent of Net Income, individuals will normally be able to claim all of the donations that they make in a year. However, if their donations exceed the 75 percent limit, or they choose not to claim all of the donations that year, any unused amounts can be carried forward. The carry forward is generally 5 years. However, for ecological gifts, the period has been extended to 10 years.

4-107. A further point here is that this limit is based on Net Income For Tax Purposes. This means that an individual could have eligible donations in excess of Taxable Income. This could occur, for example, if the individual deducted a large loss carry forward from a previous year. In situations such as this, it is important to recognize that the charitable donations tax credit is non-refundable. Given this, only the amount of donations required to reduce Tax Payable to nil should be claimed. Any additional amounts should be carried forward to future periods. Any claim that does not serve to reduce Tax Payable will simply be lost.

> **EXAMPLE** Barry Mann has Net Income For Tax Purposes of $80,000. This is reduced to a Taxable Income of $20,000 because of a large business loss carry forward from a previous year. Because of a fortuitous lottery win, he chooses to make a charitable donation of $100,000.
>
> **ANALYSIS** The potential base for Barry's charitable donations tax credit is $60,000 [(75%)($80,000)]. However, if he were to claim this amount, the credit of $17,372 [(15%)($200) + (29%)($59,800)] would be far in excess of the Tax Payable on only $20,000 of Taxable Income. Claiming the maximum amount would result in simply losing the greater part of the available credit. The preferable alternative would be to claim only enough to reduce his Tax Payable to nil and carry the remainder forward.

4-108. Determining the specific amounts to be used and carried forward will be discussed in Chapter 11.

**Exercise Four - 11**

> **Subject:** Charitable Donations Tax Credit Carry Forward
>
> For 2019, Terry Hoffman has Net Income For Tax Purposes of $350,000 and Taxable Income of $250,000. She has a charitable donation carry forward from 2018 of $225,000. Determine Ms. Hoffman's 2019 charitable donations tax credit. Until what year can she claim any unused portions of her 2018 donation?

**SOLUTION available in print and online Study Guide.**

## Medical Expense Tax Credit - ITA 118.2

### Qualifying Medical Expenses

4-109. There are many types of medical expenses which qualify for the credit under ITA 118.2. (For more detailed information, see Income Tax Folio S1-F1-C1, *Medical Expense Tax Credit.*) The current list of qualifying medical expenses includes amounts paid for:

- the services of authorized medical practitioners, dentists and registered nurses,
- prescribed drugs, medicaments and other preparations or substances, including cannabis products used for medical purposes,
- prescription eyeglasses or contact lenses,
- preventive, diagnostic and other laboratory work,
- dentures,
- premiums to private health services plans,
- the costs of home modifications for those with severe mobility restrictions, and to allow individuals confined to a wheelchair to be mobile within their home (see also the related home accessibility credit coverage beginning in Paragraph 4-79),

- guide and hearing-ear dogs and other specially trained animals, such as service animals trained to help an individual manage severe diabetes,
- artificial limbs, aids and other devices and equipment,
- products required because of incontinence,
- oxygen tents,
- the cost of rehabilitative therapy to adjust for speech or hearing loss,
- devices and equipment listed in ITR 5700 and prescribed by a medical practitioner,
- amounts paid for the design of an individualized therapy plan in situations where the cost of the therapy would be eligible for the medical expense tax credit.

4-110. Although payments for attendants, nursing home care, and care in an institution are qualifying medical expenses, there are many complications with claiming these expenses. They will be briefly covered after we have dealt with the disability tax credit.

4-111. Costs incurred for purely cosmetic reasons do not qualify for the medical expense tax credit. Examples of non-qualifying procedures include liposuction, hair replacement procedures, Botox injections and teeth whitening. Cosmetic procedures do qualify if they are required for medical or reconstructive purposes (e.g., facial surgery required due to a car accident). Perhaps wisely, the CRA refused to deal with the question of whether male infant circumcision was, or was not, cosmetic.

4-112. An important qualifying factor here is the fact that the provinces control the identification of authorized medical practitioners for the purposes of this credit. The CRA website contains a current list of these authorized medical practitioners by province. For example, acupuncturists are considered authorized in Alberta, British Columbia, Newfoundland, Ontario and Quebec, but not in other provinces. Homeopaths are currently authorized medical practitioners only in Ontario. This means that there is considerable variation between the provinces in the types of costs that qualify for the medical expense tax credit.

### Determining The Credit

4-113. Qualifying medical expenses of an individual do not include any expense for which the individual has been, or is entitled to be, reimbursed unless the amount is required to be included in income. An amount reimbursed under a public or private medical, dental or hospitalization plan would not qualify for purposes of the medical expense tax credit.

4-114. The medical expense tax credit is determined by the following formula:

**A [(B - C) + D]**, where:

**A** is the appropriate percentage for the taxation year (15 percent).

**B** is the total of an individual's medical expenses for himself, his spouse or common-law partner, and any of his children who have not reached 18 years of age at the end of the year.

**C** is the lesser of 3 percent of the individual's Net Income For Tax Purposes and $2,352 (2019 figure). Note that the B - C total cannot be negative.

**D** is the total of all amounts each of which is, in respect of a dependant of the individual (other than a child of the individual who has not attained the age of 18 years before the end of the taxation year), the amount determined by the formula

**E - F**, where:

**E** is the total of the dependant's medical expenses

**F** is the lesser of 3 percent of the dependant's Net Income For Tax Purposes and $2,352 (2019 figure).

4-115. If the taxpayer has no dependants who are 18 years of age or older, components D, E and F in the formula are not relevant. In this case, the B component is equal to the total of the qualifying medical expenses of the taxpayer, his spouse or common-law partner, and his

minor children. This balance is reduced by the C component, the lesser of 3 percent of the taxpayer's income and an indexed figure which for 2019 is equal to $2,352. This latter figure is the limiting factor if an individual's 2019 Net Income For Tax Purposes is $78,400 ($2,352 ÷ 3%) or higher.

4-116. If the taxpayer has dependants who are 18 years of age or older, a separate credit base calculation is required for each of these dependants. This credit base is equal to the dependant's qualifying medical expenses, reduced by the lesser of 3 percent of the dependant's Net Income For Tax Purposes and $2,352 (E and F in the formula). The taxpayer adds the total of these amounts to the credit base calculated for the taxpayer, his spouse or common-law partner and his minor children.

4-117. A further point here relates to who actually pays for medical expenses. Interestingly, there is a conflict between legislation and administrative practice in this area. Both ITA 118.2 and Income Tax Folio S1-F1-C1 clearly state that medical expenses can only be deducted by the individual who paid for them. However, in the T1 Guide, this rule is contradicted for couples. According to this Guide, either spouse can claim the medical expense credit, without regard to who actually paid for the expenses. This administrative position is used in practice. The T1 Guide even includes a Tax Tip which suggests that since the credit can be claimed by either spouse, a comparison should be made to choose the better result.

### Twelve Month Period

4-118. Medical expenses can be claimed for any period of 12 months that ends in the taxation year. This provision is extended to 24 months in the year of death. The ability to claim expenses for a 12 month period ending in the year is advantageous for individuals with large medical expenses in a 12 month period other than a calendar year.

**EXAMPLE** Alex Lau has Net Income For Tax Purposes of $60,000 in both 2018 and 2019. In July, 2018, he began a year long (and very painful) corrective dental surgery program. During July to December, 2018 he paid $10,000 in dental fees. During January to June, 2019 he paid $12,000 in dental fees.

**ANALYSIS** The 2018 claim could be deferred and the $22,000 total could be claimed in full in the 2019 taxation year. The advantage of doing this is that the threshold amount reduction would be applied only once in 2019. If medical expenses had to be claimed in the year in which they were incurred, Mr. Lau would have to apply the threshold reduction of $1,800 [(3%)($60,000)] in both years. If the full amount is claimed in 2019, federal tax savings would total $270 [(15%)($1,800)].

### Example Of Medical Expense Tax Credit Calculation

4-119. The following example will illustrate the medical expense tax credit formula:

**EXAMPLE** Sam Jonas and his dependent family members had the following Net Income For Tax Purposes and medical expenses for 2019. Sam paid for all of the medical expenses.

| Individual | Net Income | Medical Expenses |
|---|---|---|
| Sam Jonas | $100,000 | $ 5,000 |
| Kelly (Sam's Wife) | 12,000 | 4,400 |
| Sue (Sam's 16 Year Old Daughter) | 8,500 | 4,100 |
| Sharon (Sam's 69 Year Old Mother) | 6,000 | 16,500 |
| Martin (Sam's 70 Year Old Father) | 12,000 | 200 |
| Total Medical Expenses | | $30,200 |

**ANALYSIS** Sam's 2019 medical expense tax credit, using the formula in Paragraph 4-114, would be calculated as follows:

| | | |
|---|---|---|
| **Amount B** Qualifying Expenses ($5,000 + $4,400 + $4,100) | | $13,500 |
| **Amount C** - Lesser Of: | | |
| • [(3%)($100,000)] = $3,000 | | |
| • 2019 Threshold Amount = $2,352 | | ( 2,352) |
| Subtotal | | $11,148 |
| **Amount D** | | |
| Sharon's Medical Expenses | $16,500 | |
| Reduced By The Lesser Of: | | |
| • $2,352 | | |
| • [(3%)($6,000)] = $180 | ( 180) | 16,320 |
| Martin's Medical Expenses | $ 200 | |
| Reduced By The Lesser Of: | | |
| • $2,352 | | |
| • [(3%)($12,000)] = $360 | ( 360) | Nil* |
| Allowable Amount Of Medical Expenses | | $27,468 |
| **Amount A** The Appropriate Rate (Minimum Rate) | | 15% |
| Medical Expense Tax Credit | | $ 4,120 |

*Medical expenses can only be reduced to nil, the net result cannot be negative in this calculation.

## Exercise Four - 12

**Subject:** Medical Expense Tax Credit

Ms. Maxine Davies and her spouse, Lance Davies, have 2019 medical expenses which total $4,330. While Ms. Davies has 2019 Net Income For Tax Purposes of $150,000, Lance's only income is $360 in savings account interest. They have three children. Mandy is 12, has 2019 medical expenses of $4,600 and no Net Income For Tax Purposes. Max is 21, has 2019 medical expenses of $8,425 and Net Income For Tax Purposes of $8,250. Matt is 23, has 2019 medical expenses of $120 and Net Income For Tax Purposes of $6,000. Ms. Davies pays all of the medical expenses. Determine Ms. Davies' medical expense tax credit for 2019.

**SOLUTION available in print and online Study Guide.**

# Disability Tax Credit - ITA 118.3

## *Calculation*

4-120. The disability tax credit is available under ITA 118.3 and, for 2019, it is equal to $1,262 [(15%)( $8,416)]. In addition, there is a supplement to this amount for a disabled child who is under the age of 18 at the end of the year. For 2019, the base for the supplement is $4,909, providing a total maximum credit for a disabled minor of $1,999 [(15%)($8,416 + $4,909)]. Note, however, that the supplement amount of $4,909 is reduced by the total of amounts paid for attendant care or supervision in excess of $2,875 that are deducted as child care costs, deducted as a disability support amount, or claimed as a medical expense in calculating the medical expense tax credit. This means that once such costs reach $7,784 ($4,909 + $2,875) for the year, the supplement for a child is completely eliminated.

4-121. To qualify for the disability credit, the impairment must be such that there is a "marked" restriction of the activities of daily living or a "significant" restriction in more than one activity (while both terms are undefined, it appears that significant is less severe than marked). In addition, it must have lasted, or be expected to last, for at least 12 months.

4-122. In general, a medical doctor, nurse practitioner, or optometrist, must certify on Form T2201 that a severe physical or mental impairment exists. In the case of restrictions on the ability to walk, a physiotherapist can make the required certification.

4-123. ITA 118.4(1) tries to make the conditions for qualifying for this credit as clear as possible. This Subsection points out that an individual clearly qualifies if they are blind. They also qualify if 90 percent of the time they cannot perform, or take an inordinate amount of time to perform, a basic activity of daily living. The following are listed as basic activities:

- mental functions necessary for everyday life;
- feeding oneself or dressing oneself;
- speaking such that the individual can be understood in a quiet setting by someone familiar with the individual;
- hearing such that the individual can, in a quiet setting, understand someone familiar with the individual;
- bowel or bladder functions; or
- walking.

### *Disability Credit Transfer To A Supporting Person*

4-124. In many cases, an individual who is sufficiently infirm to qualify for the disability credit will not have sufficient Tax Payable to use it. In this situation, all or part of the credit may be transferred to a spouse, or a supporting person who claimed:

- the disabled individual as an eligible dependant under the ITA 118(1)(b); or
- claimed the Canada caregiver credit under ITA 118(1)(d) for the disabled individual.

4-125. In order to make the disability credit transfer available in situations where there is a disabled dependant who does not qualify for one of these credits, the transfer is extended (somewhat awkwardly) to situations in which the taxpayer could have claimed the eligible dependant credit or the Canada caregiver credit if:

- the taxpayer was not married; or
- the dependant had no income for the year and was over 17 years of age.

4-126. The credit amount that can be transferred is the same $1,262 that could be claimed by the disabled individual. However, if the disabled individual has Tax Payable in excess of credits under ITA 118 (personal credits), 118.01 to 118.07 (various credits including home accessibility) and 118.7 (CPP and EI credits), the credit must first be applied to reduce the disabled individual's Tax Payable to nil. If a balance remains after all Tax Payable has been eliminated, it can then be transferred to the supporting person.

4-127. Income Tax Folio S1-F1-C2, *Disability Tax Credit* provides detailed guidance on the disability tax credit, including its transfer to a supporting person.

## Exercise Four - 13

**Subject:** Disability Tax Credit

John Leslie lives with his wife and 21 year old blind son, Keith, who qualifies for the disability tax credit. Keith has no income of his own. During 2019, John paid medical expenses of $16,240 for Keith. None of these expenses involve attendant care. John's Taxable Income for 2019 was $100,000. Determine the total amount of tax credits related to Keith that will be available to John.

**SOLUTION available in print and online Study Guide.**

### *Other Credits And Deductions Related To Disabilities*

4-128. Disabled individuals, or a supporting person, may have paid significant medical expenses involving attendant care and/or nursing home care. The availability of the medical

expense tax credit for these costs is limited by the following considerations:

- Neither the individual, nor a supporting person, can claim the disability credit if a medical expense credit is claimed for a full time attendant, or for full time care in a nursing home. However, the individual or supporting person can claim either of the two amounts.
- The disability credit can be claimed if a medical expense credit is claimed for a part-time attendant. Part-time is defined as expenses claimed of less than $10,000 for the year ($20,000 in the year of death). Note that part-time attendant care can only be claimed as a medical expense credit if no part of that care is claimed as child care costs or for attendant care required to produce income.

4-129. For disabled individuals who work, or who attend a designated educational institution or secondary school, the disability supports deduction provides tax relief for a number of medical expenses, including attendant care, which would assist a disabled person to work or go to school. (See Chapter 9, Other Income, Other Deductions And Other Issues for coverage of this deduction.)

4-130. There are complications and restrictions related to claiming these and many other types of medical expenses. Complete coverage of all the relevant rules goes beyond the scope of this text. For those interested in this subject, we refer you to the Income Tax Folio 1, "*Health and Medical*". There are three Chapters that provide detailed guidance on the medical expense tax credit, (S1-F1-C1), disability tax credit (S1-F1-C2) and disability supports deduction (S1-F1-C3).

## Education Related Tax Credits

### *Tuition Fees Tax Credit - ITA 118.5(1) To ITA 118.5(4)*

4-131. Under ITA 118.5, individuals receive a credit against Tax Payable equal to 15 percent of qualifying tuition fees paid with respect to the calendar year, regardless of the year in which they are actually paid, i.e., if $5,000 in tuition is owed for the current year and $1,000 of that was prepaid in the preceding calendar year, the tuition fee credit base for the current year is $5,000. The fees must total at least $100, but there is no upper limit on this credit. The following tuition fees qualify:

- Tuition fees paid to a university, college, or other institution for post-secondary courses located in Canada.
- Tuition fees paid to an institution certified by the Minister of Employment and Social Development for a course that developed or improved skills in an occupation. Fees paid for occupational skills that are not at the post-secondary level qualify for the credit, as long as the course provides the individual with skills in an occupation. The individual must be 16 or older to qualify for the credit.
- Tuition fees paid to a university outside Canada. To qualify the course must have a minimum duration of 3 weeks.
- For individuals who live near the U.S. border and commute, tuition fees paid to a U.S. college or university for part-time studies.

4-132. It is not uncommon for employers to reimburse employees for amounts of tuition paid, particularly if the relevant course is related to the employer's business. If the reimbursement is included in the employee's income, the student can claim a credit for the tuition paid. However, if amounts reimbursed are not included in the student's income, the tuition credit is not available.

### *Ancillary And Examination Fees Included In Tuition Fees Tax Credit*

4-133. It has been noted that universities are relying more heavily on ancillary fees for such items as health services, athletics, and various other services including examinations. To the extent that such fees are required for all full time students (if the student is attending full time) or all part time students (if the student is attending part time), these fees are eligible for inclusion in the base for the tuition fees tax credit.

4-134. The general provision of ancillary fees is found in ITA 118.5(3), while the provision for ancillary examination fees is found in ITA 118.5(4).

4-135. If such fees are not required of all full time or part time students, ITA 118.5(3) allows up to $250 in such ancillary fees to be added to the total, even if they do not meet the condition of being required for all full or part time students.

4-136. In addition, ITA 118.5(4) allows up to $250 in ancillary examination fees to be added to the total if they are not required to be paid by all students taking the examination. To be eligible, the fees must exceed $100.

4-137. Eligible fees include amounts for items such as the cost of examination materials or required identification cards. It does not, however, include fees for examinations required for entrance to professional programs.

### Interest On Student Loans Tax Credit - ITA 118.62

4-138. There is a credit available under ITA 118.62 if a student or a related person has paid interest on student loans. The credit for the student is equal to 15 percent of interest paid in the year, or in any of the 5 preceding years. The interest paid must be on a loan under the *Canada Student Loans Act*, the *Canada Student Financial Assistance Act*, the *Apprentice Loans Act*, or a provincial statute governing the granting of financial assistance to students at the post-secondary school level. This credit is non-transferable.

## Exercise Four - 14

**Subject:** Education Related Tax Credits

During 2019, Sarah Bright attends university for 4 months. Her total tuition for the year, including all ancillary fees, is $3,200 of which she prepaid $1,000 in 2018. The amount paid in 2019 includes $400 in fees that are only charged to students in her geology program. Interest paid for the year on her student loan was $325. Determine the total amount of education related tax credits that would be available for Ms. Bright for 2019.

**SOLUTION available in print and online Study Guide.**

### Carry Forward Of Tuition Fees Tax Credit - ITA 118.61

4-139. There are situations in which a student does not have sufficient Tax Payable to use their tuition credit and, in addition, has not transferred it to a spouse, common-law partner, parent, or grandparent (see Paragraph 4-144).

4-140. To deal with this type of situation, ITA 118.61 allows a carry forward of unused tuition credits. There is no time limit on this carry forward. In addition, ITA 118.62 provides for a 5 year carry forward of unused interest on student loans.

4-141. Unfortunately, the calculation of the amount that is carried forward can be complex. Although the *Income Tax Act* uses Tax Payable and credit amounts to calculate carry forwards and transfers, Schedule 11 in the personal tax return uses Taxable Income and credit base amounts in its calculations. We will explain and illustrate both approaches in the example in Paragraph 4-148.

4-142. To carry amounts forward, the total available credits must be reduced by the student's Tax Payable, calculated using the following credits (note the medical expense tax credit is not included in the list):

- ITA 118 (Personal)
- ITA 118.01 Through ITA 118.07 (Various credits)
- ITA 118.3 (Disability)
- ITA 118.7 (CPP And EI)

4-143. The available amount is also reduced by transfers to other individuals. The resulting balance can be carried forward and is available for the student's personal use in any subsequent year. However, once it is carried forward, it cannot be transferred to another individual.

## Transfer Of Tuition Fees Tax Credit - ITA 118.9

4-144. ITA 118.9 provides for a transfer of the tuition tax credit to a parent or grandparent. ITA 118.8 provides for a transfer of this credit (plus several others), to a spouse or common-law partner. ITA 118.81 limits the total amount of the tuition credit that can be transferred under either of these provisions. The transfer is at the discretion of the student and the legislation states that he must indicate in writing the amount that he is willing to transfer.

4-145. The maximum transfer for an individual student is the lesser of the available credit and $5,000, multiplied by the tax rate for the minimum tax bracket (referred to as the "appropriate percentage"). This amount is $750 [(15%)($5,000)].

4-146. This $750 maximum amount must be reduced by the student's Tax Payable calculated after the same credits used to calculate the carry forward of tuition fee credits. As described in Paragraph 4-142, these are the credits available under ITA 118 through ITA 118.07, 118.3 and 118.7. If these credits reduce the student's Tax Payable to nil, the full $750 is available for transfer.

4-147. The $750 limit is on a per student basis. A parent or grandparent could have $750 transfers from any number of children or grandchildren. For obvious reasons, transfers from more than one spouse would not be acceptable for tax purposes (even if having more than one spouse could be acceptable for other purposes). If the student is married, the supporting parent or grandparent can make the claim only if the student's spouse did not claim the spousal credit, or any unused credits transferred by the student (see Paragraph 4-156).

4-148. An example will serve to illustrate both the ITA 118.9 transfer, as well as the ITA 118.81 limits on this transfer.

> **EXAMPLE** Megan Doxy has 2019 Taxable Income of $13,000, all of which is rental income. She attends university full time during 2019, paying a total amount for tuition of $8,000. Other than her tuition credit, her only other tax credit is her personal amount of $1,810 [(15%)($12,069)]. She would like to transfer the maximum credits to her father.
>
> **ANALYSIS - Income Tax Act Approach** Megan's tuition credit is $1,200 [(15%)($8,000)], well in excess of the maximum transfer of $750. However, this maximum of $750 would have to be reduced by Megan's Tax Payable after the deduction of her personal amount. This amount would be $140 [(15%)($13,000 - $12,069)], leaving a maximum transfer of $610 ($750 - $140). This would leave Megan with a remaining unused credit of $450 ($1,200 - $140 - $610) which can be carried forward to future years, but only for her own use. These calculations are the result of using the approach presented in the *Income Tax Act*.
>
> **ANALYSIS - Tax Return Approach** The alternative calculation approach that is used in the tax return begins with the total tuition amount of $8,000. The maximum transfer amount in this approach is $5,000. This would be reduced by $931 ($13,000 - $12,069), the excess of Megan's Taxable Income over her basic personal amount. This results in a maximum transfer of $4,069 ($5,000 - $931). Megan's carry forward amount is $3,000 ($8,000 - $931 - $4,069). Multiplying these amounts by 15 percent gives the same $610 [(15%)($4,069)] transfer and $450 [(15%)($3,000)] of unused credits as the preceding *Income Tax Act* approach.

## Exercise Four - 15

**Subject:** Transfer And Carry Forward Of Tuition Tax Credits

Jerry Fall has 2019 Taxable Income of $12,600. He attends an American university during 2019, paying a total amount for tuition of $23,500 (Canadian dollars). His only tax credits, other than the tuition credit, are his basic personal credit and a medical expense credit of $233 [(15%)($1,555)]. Determine Jerry's total tuition tax credit and indicate how much of this total could be transferred to a parent and how much would be carried forward.

**SOLUTION available in print and online Study Guide.**

## Employment Insurance (EI) And Canada Pension Plan (CPP) Tax Credits - ITA 118.7

4-149. ITA 118.7 provides a tax credit equal to 15 percent of the Employment Insurance (EI) premiums paid by an individual, all of the Canada Pension Plan (CPP) contributions paid on employment income, and half of the CPP contributions paid on self-employed income.

4-150. For 2019, an employee's CPP contributions are based on maximum pensionable earnings of $57,400, less a basic exemption of $3,500. The rate for 2019 is 5.1 percent, resulting in a maximum contribution of $2,749 [(5.1%)($57,400 - $3,500)]. This provides for a maximum 2019 credit against federal Tax Payable of $412 [(15%)($2,749)]. The employer matches the contributions made by the employee. However, this matching payment has no tax consequences for the employee.

4-151. A self-employed individual earning business income must make a matching CPP contribution for himself, effectively paying twice the amount he would as an employee. As discussed in Chapter 9, the matching contribution is a deduction from Net Income For Tax Purposes under ITA 60(e) (a Division B, Subdivision e deduction). This treatment for the matching CPP contribution as a deduction is analogous to the treatment used by employers. This means that a self-employed individual will have a tax credit equal to one-half of his CPP contributions for self-employed income, and a deduction for the remaining one-half.

4-152. For 2019, EI premiums are based on maximum insurable earnings of $53,100. The employee's rate is 1.62 percent, resulting in a maximum annual premium of $860. This results in a maximum credit against federal Tax Payable of $129 [(15%)($860)].

4-153. Employers are also required to pay EI premiums, the amount being 1.4 times the premiums paid by the employee. However, these employer paid premiums have no tax consequences for the employee. While self-employed individuals can elect to participate in the EI program, unlike for the CPP, they do not have to remit the employer's share. Their premiums will be limited to the same maximum of $860 that is applicable to employees.

## Overpayment Of EI Premiums And CPP Contributions

4-154. It is not uncommon for employers to withhold EI and CPP amounts that are in excess of the amounts required. This can happen through an error on the part of the employer's payroll system, especially for employees with variable hours. Even in the absence of errors, overpayments can arise when an individual changes employers or has multiple employers. We would note that the CRA's form T2204 is designed to assist taxpayers in calculating any overpayment of EI. Schedule 8 of the T1 provides similar assistance in calculating any CPP overpayment.

4-155. A refund of these excess amounts is available when an individual files his tax return. While any CPP or EI overpayment is not part of the base for the tax credit, it will increase the refund available or decrease the tax liability that is calculated in the return.

**EXAMPLE** Jerry Weist changed employers during 2019 and, as a consequence, the total amount of EI premiums withheld during the year was $957. In a similar fashion, the total amount of CPP contributions withheld by the two employers was $2,798. His employment income was well in excess of the maximum insurable and pensionable earnings.

**ANALYSIS** In filing his 2019 tax return, Jerry will claim a refund of $146, calculated as follows:

| | | |
|---|---|---|
| EI Premiums Withheld | $ 957 | |
| 2019 Maximum | ( 860) | $ 97 |
| CPP Contributions Withheld | $2,798 | |
| 2019 Maximum | ( 2,749) | 49 |
| Refund | | $146 |

## Transfers To A Spouse Or Common-Law Partner - ITA 118.8

4-156. In the preceding material, we have covered several tax credits that can be claimed by either spouse, such as the charitable donations credit. There are also four tax credits that can be transferred to a spouse or common-law partner under ITA 118.8. They are:

- the age tax credit (see Paragraph 4-62),
- the pension income tax credit (see Paragraph 4-64),
- the disability tax credit (see Paragraph 4-120), and
- the tuition fees tax credit to a maximum of $750 (see material beginning in Paragraph 4-144).

4-157. The maximum amount that can be transferred is based on the sum of the preceding credits, reduced by a modified calculation of the spouse or common-law partner's Tax Payable. While the legislation is based on Tax Payable, the T1 tax return uses a simplified approach based on Taxable Income, much like the alternative calculation for the tuition credit transfer. This approach starts with the sum of the base for all of the preceding credits. From this amount is subtracted the spouse's taxable income, reduced by the bases of:

- the basic personal credit,
- the Canada employment credit, CPP and EI credits,
- the credits under ITA 118.01 through ITA 118.07 (various credits including the first time home buyers credit and the adoption expenses credit),
- the tuition fees tax credit.

4-158. The resulting remainder, if any, is the amount that can be transferred to a spouse or common-law partner.

### Exercise Four - 16

**Subject:** Transfer Of Credits From A Spouse

Mr. Martin Levee is 68 years old and has Net Income For Tax Purposes of $42,000. Of this total, $24,000 was from a life annuity that he purchased with funds in his RRSP. His spouse is 66 years old and blind. She has no income of her own (she is ineligible for OAS), and is attending university on a full time basis for 4 months of 2019. Her tuition fees for the year were $2,200 . Determine Mr. Levee's maximum tax credits for 2019. Ignore the possibility of splitting his pension income with his spouse.

**SOLUTION available in print and online Study Guide.**

**We suggest you work Self Study Problems Four-2 and 3 at this point.**

## Political Contributions Tax Credits - ITA 127(3)

### *Canada Elections Act*

4-159. While no changes have been made in the *Income Tax Act*, the *Canada Elections Act* limits the ability to make political contributions to individuals only. More specifically, this *Act* contains the following provisions:

- There is a total ban on contributions by corporations, trade unions and unincorporated associations.
- For 2019, the amount that can be contributed by an individual:
  - to each registered party,
  - in total to all the registered associations, nomination contestants and candidates of each registered party,
  - in total to all leadership contestants in a particular contest, and
  - to each independent candidate

  is limited to $1,600 for the year. The limits increase by $25 on January 1 in each subsequent year.

### *Income Tax Rules*

4-160. A federal tax credit is available on monetary political contributions made to a registered federal political party, or to candidates at the time of a federal general election or by-election. The maximum value is $650 and it is available to both individuals and corporations.

4-161. However, as discussed in the preceding Paragraph, the *Canada Elections Act* totally bans contributions by corporations. The credit is calculated as follows:

| | Contributions | Credit Rate | Tax Credit |
|---|---|---|---|
| First | $ 400 | 3/4 | $300 |
| Next | 350 | 1/2 | 175 |
| Next | 525 | 1/3 | 175 |
| Maximum Credit | $1,275 | | $650 |

4-162. The $650 credit is achieved when contributions total $1,275. Contributions in excess of this amount do not generate additional credits. Also note that most provinces have a similar credit against provincial Tax Payable. There is a difference, however, in that the eligible contributions must be made to a registered provincial political party.

### Exercise Four - 17

**Subject:** Political Contributions Tax Credit

Ms. Vivacia Unger contributes $785 to the Liberal New Conservative Democratic Party, a registered federal political party. Determine the amount of her federal political contributions tax credit.

**SOLUTION available in print and online Study Guide.**

## Labour Sponsored Venture Capital Corporations Credit - ITA 127.4

4-163. Labour Sponsored Venture Capital Corporations (LSVCCs) are a form of mutual fund corporation, sponsored by an eligible labour organization, and mandated to provide venture capital to small and medium sized businesses.

4-164. There is a 15 percent federal tax credit for provincially registered LSVCCs prescribed under the ITA. The maximum credit available is $750 [(15%)($5,000 net cost of shares)]. To be eligible for the federal credit, the provincially registered LSVCC would need to:

- be eligible for a provincial tax credit of at least 15 percent of the cost of an individual's shares;
- be sponsored by an eligible labour body; and
- mandate that at least 60 percent of the LSVCC's shareholders' equity be investments in small and medium sized enterprises.

## Dividend Tax Credit

4-165. The dividend tax credit is covered in Chapter 7 as part of our discussion of property income.

## Foreign Tax Credits

4-166. The credits that are available for taxes paid in foreign jurisdictions are covered in Chapters 7 and 11.

## Investment Tax Credits

4-167. When taxpayers make certain types of expenditures, they become eligible for investment tax credits. These credits reduce federal Tax Payable. While these credits can be claimed by individuals as well as corporations, they are much more commonly used by corporations and, as a consequence, we cover investment tax credits in Chapter 14.

**We suggest you work Self Study Problems Four-4 and Four-5 at this point.**

# Refundable Credits

## Introduction

4-168. The credits that we have encountered to this point can be described as non-refundable. This means that, unless the taxpayer has Tax Payable for the current taxation year, there is no benefit from the credit. Further, with the exception of the charitable donations credit and education related credits, there is no carry forward of these non-refundable credits to subsequent taxation years. This means that, if the credits are not used in the current year, they are permanently lost.

4-169. In contrast, refundable credits are paid to the taxpayer, without regard to whether that individual has a Tax Payable balance. In this section we will describe six of these refundable credits.

- The GST/HST tax credit;
- the refundable medical expense supplement;
- the Canada Workers Benefit;
- the refundable teacher and early childhood educator school supply tax credit;
- Climate Action Incentive payments (available in only some provinces and territories); and
- the Canada Training Credit.

4-170. With respect to the GST/HST credit, our coverage will be limited. This reflects the fact that, unlike the other four refundable credits, taxpayers do not calculate the GST/HST credit in their tax returns. Rather, the CRA calculates the credit from the tax returns that the taxpayer has filed in previous years and pays the amount to the eligible taxpayers. Given this, there is no need to provide coverage of the detailed calculation of this credit.

## GST/HST Credit - ITA 122.5

4-171. One of the major problems with the goods and services tax (GST) is the fact that it is a regressive tax (see discussion in Chapter 1). In order to provide some relief from the impact of the GST on low income families, there is a refundable GST credit available under ITA 122.5.

4-172. The GST/HST credit is determined by the CRA on the basis of eligibility information supplied in the individual's tax returns for previous years. Because of this, it is only paid to individuals who file tax returns.

4-173. The amount of the credit, as well as the relevant income threshold, is indexed on the same basis as other credits. The relevant amounts for 2019 are as follows:

- $290 for the "eligible individual". An eligible individual includes a Canadian resident who is 19 years of age or over during the current taxation year, or is married or living common-law, or is a parent who resides with their child. In the case of a married couple, only one spouse can be an eligible individual.
- $290 for a "qualified relation". A qualified relation is defined as a cohabiting spouse or common-law partner. If the eligible individual does not have a qualified relation, he is entitled to an additional credit that is the lesser of $153 and 2 percent of the individual's Net Income For Tax Purposes in excess of $9,412.
- $290 for a dependant eligible for the eligible dependant tax credit.
- $153 for each "qualified dependant". A "qualified dependant" is defined as a person who is the individual's child or is dependent on the individual or the individual's cohabiting spouse or common-law partner for support. In addition, the child or dependent person must be under 19 years of age, reside with the individual, have never had a spouse or common-law partner, and have never been a parent of a child he has resided with.

4-174. The total of these amounts must be reduced by 5 percent of the excess of the individual's 2017 "adjusted income" over an indexed threshold amount of $37,789. The system uses information provided on the 2017 tax return, since this return is normally filed by early 2018. "Adjusted Income" is defined as total income of the individual and his qualified relation, if any.

4-175. The GST/HST credit is available to all eligible individuals, without regard to whether they have Tax Payable. The amount of the credit is calculated by the CRA on the basis of information included in the individual's tax return for a particular year, and the amounts are automatically paid to the taxpayer in subsequent years.

## Refundable Medical Expense Supplement - ITA 122.51

4-176. The calculation of the GST/HST credit is not included in the tax return. The four other refundable credits, including the refundable medical expense supplement, are included in the tax return.

4-177. To be eligible for the 2019 medical expense supplement, the individual must be 18 or over at the end of the year, and must have income (employment or business) of at least $3,645. The credit is the lesser of $1,248 and 25/15 of the medical expense tax credit that can be claimed for the year.

4-178. The lesser amount is reduced by 5 percent of "family net income" in excess of an indexed threshold amount. Family net income is the sum of the income of the taxpayer and his spouse or common-law partner, but not that of an eligible dependant. For 2019, the income threshold is $27,639 and the credit is completely eliminated when family net income reaches $52,599 [($1,248 ÷ 5%) + $27,639]. A simple example will serve to illustrate this provision:

> **EXAMPLE** For 2019, Mr. Larry Futon and his spouse have medical expenses that total $5,000. His Net Income For Tax Purposes is $28,900, all of which is employment income. His spouse has Net Income For Tax Purposes of $500. Mr. Futon claims the Canada caregiver tax credit for his mother who has Net Income of $8,000. He has no tax credits other than personal and medical credits.

**ANALYSIS** Mr. Futon's allowable medical expenses for tax credit purposes would be $4,133 [$5,000 - (3%)($28,900)], resulting in a tax credit of $620 [(15%)($4,133)]. Given this, 25/15 of the credit would equal $1,033 [(25/15)($620)]. Since this is less than the maximum of $1,248, his refundable credit would be $1,033 less a reduction of $88 [(5%)($28,900 + $500 - $27,639)], leaving a balance of $945 ($1,033 - $88).

4-179. The receipt of this refundable credit does not affect an individual's ability to claim a tax credit for the same medical expenses that are used to calculate the refundable credit. In the preceding example, Mr. Futon's basic personal, spousal, Canada caregiver, and medical expense credit bases total $34,911 [$12,069 + ($12,069 - $500) + $7,140 + $4,133]. This is more than his Taxable Income of $28,900 which results in his federal Tax Payable being nil. This means that he will be able to claim the entire $945 as a refund.

### Exercise Four - 18

**Subject:** Refundable Medical Expense Supplement

During 2019, Ms. Lara Brunt and her common-law partner, Sara, have medical expenses that total $6,250. Her Net Income For Tax Purposes is $28,400, all of which qualifies as income for the Refundable Medical Expense Supplement. Sara has no income of her own. Determine Lara's minimum Tax Payable for 2019. Ignore any credits other than the basic, spousal and medical expense related credits.

**SOLUTION available in print and online Study Guide.**

## Canada Workers Benefit - ITA 122.7 (Formerly Working Income Tax Benefit)

### *The Welfare Wall*

4-180. Despite the rantings of ostensibly virtuous individuals of a right-wing persuasion, many individuals who are receiving various types of social assistance are not necessarily lazy or lacking in motivation. The simple fact is that, given the types of wages such individuals receive, they are often better off economically if they do not work. The types of wages that such individuals can earn are typically at the legal "minimum" (e.g., the minimum wage ranges from $11.35 in Manitoba to $15.00 per hour in Alberta). The amounts earned at this wage are typically offset by reductions in social assistance payments. Additional negative effects flow from loss of subsidized housing, prescription drug assistance, and other benefits that are available to individuals with little or no income.

4-181. It has been demonstrated that, if such individuals find employment, the result can be a reduction in their real income. Instead of rewarding their efforts, our current system can actually punish individuals who make an effort to improve their economic status. This is commonly referred to as the welfare wall.

### *Calculation Of The Canada Workers Benefit*

4-182 To deal with this problem, the *Income Tax Act* provides a refundable credit for individuals over the age of 19 and have working income in excess of $3,000. Working income is defined as gross employment income (i.e., no employment expenses deducted), business income, scholarships, and research grants. The amount of the benefit will depend on whether the individual is single or, alternatively, has a spouse or an eligible dependant. For this purpose, an eligible dependant is a child who lives with the individual and who is under the age of 19 at the end of the year.

4-183. Unfortunately, the calculation of this benefit is fairly complex and, in addition, there is a significant lag in the availability of relevant parameters for the current year. Given this, we have decided not to include detailed coverage of the calculation of this refundable credit. We have, however, provided sufficient information about the general nature of the benefit that

users of this material will be aware of when this refundable credit might be available. Effective for 2019, the federal government has strengthened the former Working Income Tax Benefit and turned it into a new Canada Workers Benefit.

## Refundable Teacher And Early Childhood Educator School Supply Tax Credit - ITA 122.9

4-184. The government has observed that early childhood educators often use their own fund to acquire supplies for the purpose of teaching or enhancing students' learning. In recognition of this situation, an eligible educator can claim a 15 percent tax credit for up to $1,000 of eligible expenditures. While it is unlikely that employed teachers will lack sufficient Tax Payable to claim the credit, the credit is refundable.

4-185. The definitions relevant to this credit are as follows:

**Eligible Educator** To be eligible for this credit, a teacher will need to have a teacher's certificate that is valid in the province where they are employed. Early childhood educators qualify if they hold either a teacher's certificate or a diploma in early childhood education that is recognized by the province in which they are employed.

**Eligible Supplies** Eligible supplies will include the following durable goods:

- games and puzzles;
- supplementary books for classrooms;
- educational support software;
- or containers such as plastic boxes for themes and kits.

Eligible supplies will also include consumable goods such as:

- construction paper for activities, flashcards, or activity centres;
- items for science experiments, such as seeds, potting soil, vinegar, and stir sticks;
- art supplies, such as paper, glue, and paint; and
- various stationery items, such as pens, pencils, posters, and charts.

4-186. For the cost of supplies to qualify for this credit, employers will be required to certify that the supplies were purchased for the purpose of teaching or otherwise enhancing learning in a classroom or learning environment. Claimants will be required to retain their receipts for eligible purchases.

## Climate Action Incentive Payments

### *Background*

4-187. Carbon tax plans are recognized as an effective way of dealing with the crucial problem of global warming. Globally speaking, there is always some opposition to any plan that deals with the negative influence of carbon on the environment. All such plans involve penalizing some group, or economic sector, in order to reduce the influence of carbon on the environment and, not surprisingly, such groups or sectors create arguments to support their opposition to the applied penalties.

4-188. At the federal level, the government of Canada has adopted such a plan and the federal carbon tax was, of course, no exception to opposition. Several provinces have objected to this federal initiative and have refused to accept it in their jurisdictions. For these provinces, the federal government offered an alternative. If they adopted a robust plan of their own for dealing with climate change, there would be no consequences related to rejecting the federal carbon tax.

4-189. Showing a disregard for the critical issue of climate change, four provinces and two territories have rejected the federal plan and have no effective plan of their own. These provinces and territories are:

- Four provinces - Manitoba, New Brunswick, Ontario, and Saskatchewan
- Two territories - Nunavut and Yukon

4-190. In order to ensure that there is a price on carbon pollution throughout Canada, the federal government has introduced the *Greenhouse Gas Pollution Pricing Act*. This is a federal fuel charge that will apply only in those four provinces and two territories that neither accepted the federal carbon tax nor adopted a pollution control plan of their own.

### The Refundable Credit

4-191. In applying this fuel tax, it was not the intent of the federal government to increase tax revenues. The macro effects of the fuel tax will be offset by a refundable credit which the federal government has referred to as the Climate Action Incentive payment. It is expected that these payments, while making the use of polluting fossil fuels more expensive, will distribute to the residents of the provinces and territories where the fuel tax is applied, an amount that is supposed to roughly offset the cost of the fuel tax for residents.

4-192. This payment is implemented through the federal income tax system in the form of a refundable tax credit. Individuals aged 18 and older have to file a tax return in order to receive this Climate Action Incentive payment even if they wouldn't otherwise be required to file a tax return. This process is analogous to that applicable to the GST credit.

4-193. The amount of the payments vary by province. The total paid is based on the number of dependants (family size) and is not income dependent. It was in effect for 2018. As an example of the amounts, the 2019 figures for Ontario are as follows:

| Family Member | Payment |
|---|---|
| Single adult or first family member | $154 |
| Second adult in a couple or for the first child of a single parent | 77 |
| First child of family or second child of a single parent | 38 |
| Each additional child | 38 |
| Total For A Family Of Four | $307 |

4-194. The anticipated 2019 payments for a single adult for the four provinces are: New Brunswick ($128), Ontario ($154 table above), Manitoba ($170) and Saskatchewan ($305). Figures are not currently available for Yukon and Nunavut territories.

## Canada Training Credit - ITA 122.91 (Proposed)

### The Credit Base

4-195. The government is interested in encouraging working individuals to improve their professional skills. To this end, the 2019 budget is introducing the Canada Training Credit. In somewhat simplified terms, this proposal allows one-half of amounts that would normally be eligible for the 15 percent tuition tax credit, to be eligible for a refund. Note that refunds reduce the amount that is eligible for the tuition credit.

4-196. Eligibility for the tuition tax credit was discussed beginning in Paragraph 4-129. In general, the amount eligible for the Canada Training Credit will be the same as the amount that qualified for the tuition tax credit. The one exception to this is amounts paid to educational institutions outside of Canada. While these amounts will continue to be eligible for the tuition tax credit, they will not be eligible for the Canada Training Credit.

4-197. Despite the fact that the draft legislation states that it comes into force on January 1, 2019, the Training Account Limit for the Canada Training Credit only begins to accumulate in 2020. It accumulates at a rate of $250 per year, including years in which a refund is claimed. To be eligible for this annual addition to the Trading Account Limit, an individual must:

- file a tax return for the year of accumulation;
- be at least 25 years of age and less than 65 years of age;
- be a resident of Canada throughout the year;
- have earnings, subject to indexation, of $10,000 or more during the year (including employment income, self-employed income, maternity EI benefits, and taxable scholarship income); and

- have Net Income For Tax Purposes in the preceding year that does not exceed the top of the third tax bracket ($147,667 for 2019).

4-198. Over their lifetime, individuals will be able to add a maximum of $5,000 to their Canada Training account. This provides for adding the annual amount of $250 in each of 20 years. However, any unused amount that is present in the year an individual turns 65 will expire at the end of that year.

### *Calculating The Refund*

4-199. The actual refund will be equal to the lesser of:

- one-half of eligible training/tuition costs for the current year; and
- the balance in the individual's Canada Training account for the preceding year.

**NOTE** As the Training Account Limit has no additions prior to 2020 and actual refunds are based on the balance in this account in the previous year, there will be no benefits received from this refundable credit prior to 2021.

4-200. An example will serve to illustrate the required calculations.

**EXAMPLE** Michael is eligible to accumulate an amount in his Canada Training account in each of the years 2020 through 2022. This means that his preceding year balance for 2023 is $750 [(3)($250)]. During 2023 he pays $1,500 in eligible tuition fees.

**ANALYSIS** For 2023, Michael can claim a refundable tax credit equal to $750. This is both one-half of the training costs of $1,500, as well as the balance in his Canada Training account for 2022. The other $750 of the tuition fees can be used to claim a non-refundable tuition tax credit of $112.50 [(15%)($750)].

At the end of 2023, the balance in his Canada Training account will be $250 ($750 opening balance + $250 for 2023 - $750 claimed in 2023). For 2024 and subsequent years, he can accumulate an additional $4,000 in his Canada Training account. This is the accumulation limit of $5,000, less the $250 per year that was added during the 4 years 2020 through 2023.

### *Implementation*

4-201. While the legislation refers to application as of January 1, 2019, accumulation of a Training Account Limit will only begin in 2020. No refund will be available until 2021.

# Social Benefits Repayment (OAS And EI)

## Basic Concepts

### *Clawbacks*

4-202. Many Canadian tax credits and benefits are available on a universal basis, without regard to the income level of the recipient. However, both Old Age Security payments (OAS) and Employment Insurance payments (EI) are reduced for higher income individuals.

4-203. With respect to OAS payments, the government assesses a Part I.2 tax on OAS benefits received by individuals with an adjusted Net Income above a threshold amount. In similar fashion, the *Employment Insurance Act* requires that individuals with an adjusted Net Income above a specified threshold amount repay a portion of any Employment Insurance (EI) benefits received. These required repayments are commonly referred to as "clawbacks".

### *Treatment In Net And Taxable Income*

4-204. Both OAS payments received and EI payments received must be included in an individual's Net Income For Tax Purposes. However, in situations where part or all of these amounts must be repaid, it would not be equitable to have the full amounts received flow through to Taxable Income and be fully taxed.

4-205. This problem is dealt with by providing a deduction for amounts repaid. You may recall from Chapter 1 that one of the components of Net Income For Tax Purposes was Other Deductions (subdivision e of the *Income Tax Act*). While we will not provide detailed coverage of this subdivision until Chapter 9, we need to note here that ITA 60(v.1) provides a deduction for repayments of EI, and ITA 60(w) provides a deduction for repayment of OAS amounts.

4-206. As both the EI and OAS repayments are calculated on the basis of the individual's income in excess of a threshold amount, the question arises as to whether these tests should be applied using income figures which include the full amount received or, alternatively, income figures from which the repayments have been deducted. The solution to this problem will be discussed in the two sections which follow.

## Employment Insurance (EI) Benefits Clawback

4-207. The *Employment Insurance Act* requires the partial repayment of benefits received if the recipient's threshold income is greater than $66,375 (1.25 times the 2019 maximum insurable earnings of $53,100). This $66,375 income figure includes all of the components of Net Income For Tax Purposes except the deductions for repayment of EI benefits [ITA 60(v.1)] and the deduction for the repayment of OAS benefits [ITA 60(w)]. As the EI clawback is deducted from the threshold income used for determining the OAS clawback, the EI clawback must be determined prior to calculating any amount of OAS clawback.

4-208. Once the amount of threshold income over $66,375 is determined, it must be compared to the EI benefits included in the current year's Net Income For Tax Purposes. The lesser of these two amounts is multiplied by 30 percent and this becomes the amount that must be repaid for the year as a social benefits repayment. This amount can then be deducted under ITA 60(v.1) in the determination of Net Income For Tax Purposes for the year.

## Old Age Security (OAS) Benefits Clawback

4-209. The OAS clawback is the lesser of the OAS payments included in income and 15 percent of the taxpayer's income in excess of the $77,580 income threshold. For this purpose, income is equal to Net Income For Tax Purposes computed after any EI clawback, but before consideration of the deduction for the OAS clawback.

4-210. The current annual benefit from OAS is about $7,400. Assuming this to be the correct figure, all of the OAS benefit would be clawed back when the individual's Net Income For Tax Purposes reaches $126,913 [($7,400 ÷ 15%) + $77,580].

4-211. For higher income seniors, OAS benefits are clawed back on a regular basis, with some individuals never receiving benefits during their lifetime. Given this, the government has an administrative procedure under which they withhold payments that they expect to be clawed back. Expectations are based on tax returns filed in the two previous years.

> **EXAMPLE** In her tax returns for both 2017 and 2018, Sally Leung has reported Taxable Income in excess of $200,000 per year. Despite the fact that Sally is 70 years of age, she would receive no OAS payments in 2019.

4-212. It is important to understand the procedures related to OAS payments. In their first year of eligibility for OAS, individuals will automatically be enrolled in this program. Unless they take action to defer the payments, they will begin immediately.

## Exercise Four - 19

**Subject:** EI and OAS Clawbacks

For 2019, Ms. Marilyn Jacobi has net employment income of $65,000, receives EI payments of $10,000, and receives $7,400 in Old Age Security (OAS) payments. No amount was withheld from the OAS payments because she had very low income in the previous two years due to large rental losses. Determine Ms. Jacobi's Net Income For Tax Purposes for 2019.

**SOLUTION available in print and online Study Guide.**

# Comprehensive Example

4-213. While this Chapter has provided a reasonably detailed description of the determination of Tax Payable for individuals, including small examples of some of the issues that arise in this process, a more comprehensive example is appropriate at this point. To focus on the federal tax calculations, we have ignored provincial income taxes and income tax withholdings on employment income.

## *Basic Data*

Mr. Thomas Baxter is 66 years of age and his 2019 income is made up of net employment income of $73,800 and Old Age Security benefits of $7,400 (because of large business losses during the previous two years, no amount was withheld from these payments). Mr. Baxter and his family live in Nanaimo, B.C.

For 2019, Mr. Baxter's employer withheld maximum CPP and EI contributions. Other information pertaining to 2019 is as follows:

1. Mr. Baxter's spouse is 49 years old and qualifies for the disability tax credit. Her income for the year totalled $5,000.
2. Mr. and Mrs. Baxter have two daughters, Kim, aged 14 and Lori, aged 17. Kim had income of $2,700 for the year while Lori had net income of $2,000. In September, 2019, Lori began full time attendance at a Canadian university. Mr. Baxter paid her tuition fees of $5,000, of which $2,500 was for the fall, 2019 semester. Lori is willing to transfer her tuition credit to her father.
3. The family medical expenses for the year, all of which were paid by Mr. Baxter, totalled $2,843. Of this amount, $300 was paid for Kim and $900 for Lori.
4. During the year, Mr. Baxter made cash donations to registered Canadian charities in the amount of $3,000.
5. During the year, Mr. Baxter made contributions to federal political parties totalling $800.

## *Net And Taxable Income*

| | |
|---|---|
| Net Employment Income | $73,800 |
| OAS Benefits | 7,400 |
| Net Income Before Clawback | $81,200 |
| OAS Clawback (Note One) | ( 543) |
| Net Income For Tax Purposes And Taxable Income | $80,657 |

**Note One** The required repayment of OAS is the lesser of:

- $7,400, the OAS payments included in income, and
- $543 [(15%)($81,200 - $77,580)].

## Tax Payable/Federal Balance Owing

As Mr. Baxter is a resident of B.C. he is not eligible for the Climate Action Incentive payment. His federal tax payable and balance owing is calculated as follows:

| | | |
|---|---|---|
| Federal Tax On First $47,630 | | $ 7,145 |
| Federal Tax On Next $33,027 ($80,657 - $47,630) At 20.5% | | 6,771 |
| Gross Tax | | $13,916 |
| Tax Credits: | | |
| Basic Personal Amount | ($12,069) | |
| Spousal Including Infirm Amount | | |
| ($12,069 + $2,230 - $5,000) | ( 9,299) | |
| Additional Caregiver Amount (Note Two) | Nil | |
| EI Premiums (Maximum) | ( 860) | |
| CPP Contributions (Maximum) | ( 2,749) | |
| Canada Employment | ( 1,222) | |
| Age [$7,494 - (15%)($80,657 - $37,790)] | ( 1,064) | |
| Medical Expenses (Note Three) | ( 491) | |
| Mrs. Baxter's Disability Transferred | ( 8,416) | |
| Lori's Tuition For 2019 Transferred | | |
| ($5,000 - $2,500) (Note Four) | ( 2,500) | |
| Total | ($38,670) | |
| Rate | 15% | ( 5,800) |
| Charitable Donations (Note Five) | | |
| {[(15%)($200)] + [(33%)(Nil)]+ [(29%)($3,000 - $200)]} | | ( 842) |
| Political Contributions Tax Credit | | |
| [($400)(3/4) + ($350)(1/2) + ($50)(1/3)] | | ( 492) |
| Federal Tax Payable | | $ 6,782 |
| Social Benefits Repayment (Note One) | | 543 |
| Federal Balance Owing | | $ 7,325 |

**Note Two** As the spousal amount is larger than the Canada caregiver amount of $7,140, there is no additional Canada caregiver amount.

**Note Three** Since both daughters are under 18 at the end of the year, their expenses can be aggregated with those of Mr. Baxter for the purposes of this calculation.

| | |
|---|---|
| Total Medical Expenses | $2,843 |
| Lesser Of: | |
| • [(3%)($80,657)] = $2,420 | |
| • 2019 Threshold Amount = $2,352 | ( 2,352) |
| Allowable Amount Of Medical Expenses | $ 491 |

**Note Four** Since Lori has no Tax Payable before consideration of her tuition credit, it can be all be transferred to her supporting parent as it totals less than the $5,000 transfer limit. Alternatively, she could have chosen to carry forward these credits to apply against her own Tax Payable in a subsequent year.

**Note Five** Since none of Mr. Baxter's income is taxed at 33 percent, this rate is not used to calculate the charitable donations credit.

**We suggest you work Self Study Problems Four-6 to Four-8 at this point.**

**Additional Supplementary Self Study Problems Are Available Online.**

# Key Terms Used In This Chapter

4-214. The following is a list of the key terms used in this Chapter. These terms, and their meanings, are compiled in the Glossary located at the back of the Study Guide.

Adoption Expenses Tax Credit
Age Tax Credit
Canada Caregiver Amount For Child
Canada Caregiver Tax Credit
Canada Employment Credit
Canada Pension Plan (CPP)
Canada Pension Plan Tax Credit
Canada Training Credit
Canada Workers Benefit
Charitable Donations Tax Credit
Charitable Gifts
Clawback
Climate Action Incentive Payment
Common-Law Partner
Dependant
Digital News Subscription Credit
Disability Tax Credit
Disability Tax Credit Supplement
Eligible Dependant Tax Credit
Employment Insurance (EI)
Employment Insurance Tax Credit
First Time Home Buyer's Tax Credit
GST Tax Credit
Home Accessibility Tax Credit
Indexation
Labour Sponsored Funds Tax Credit
Medical Expense Tax Credit
Non-Refundable Tax Credit
Northern Residents Deductions
OAS Clawback
Old Age Security (OAS) Benefits
Pension Income Tax Credit
Personal Tax Credits
Political Contributions Tax Credit
Progressive Tax System
Refundable Medical Expense Supplement
Refundable Tax Credit
Regressive Tax System
Social Benefits Repayment
Spousal Tax Credit
Spouse
Student Loan Interest Credit
Tax Credit
Taxable Income
Teacher School Supply Tax Credit
Tuition Fees Tax Credit
Volunteer Firefighters Tax Credit
Volunteer Search And Rescue Tax Credit
Wholly Dependent Person

# References

4-215. For more detailed study of the material in this Chapter, we would refer you to:

| | |
|---|---|
| ITA 110 | Deductions Permitted |
| ITA 111.1 | Order Of Applying Provisions |
| ITA 117 | Individual Taxes Payable |
| ITA 117.1 | Annual Adjustment (Indexation) |
| ITA 118(1) | Personal Credits |
| ITA 118(2) | Age Credit |
| ITA 118(3) | Pension Credit |
| ITA 118(10) | Canada Employment Credit |
| ITA 118.01 | Adoption Expense Credit |
| ITA 118.041 | Home Accessibility Tax Credit |
| ITA 118.05 | First-Time Home Buyers' Credit |
| ITA 118.06 | Volunteer Firefighters Tax Credit |
| ITA 118.07 | Volunteer Search And Rescue Workers Tax Credit |

| | |
|---|---|
| ITA 118.1 | Definitions (Charitable Gifts) |
| ITA 118.2 | Medical Expense Credit |
| ITA 118.3 | Credit For Mental Or Physical Impairment |
| ITA 118.5 | Tuition And Other Education Related Credits |
| ITA 118.61 | Unused Tuition, Textbook And Education Tax Credits |
| ITA 118.62 | Credit For Interest On Student Loan |
| ITA 118.7 | Credit For EI And QPIP Premiums And CPP Contributions |
| ITA 118.8 | Transfer Of Unused Credits To Spouse Or Common-Law Partner |
| ITA 118.81 | Tuition Tax Credit Transferred |
| ITA 118.9 | Transfer To Parent Or Grandparent |
| ITA 122.5 | GST/HST Credit |
| ITA 122.51 | Refundable Medical Expense Supplement |
| ITA 122.7 | Canada Worker's Benefit (Formerly Working Income Tax Benefit) |
| ITA 127(3) | Federal Political Contributions Tax Credit |
| ITA 127.4 | Labour Sponsored Venture Capital Corporations Credit |
| ITA 180.2 | OAS Clawback |
| ITR 5700 | Prescribed Devices Or Equipment Or Equipment For The Medical Expense Tax Credit. |
| IC 75-2R9 | Contributions To A Registered Political Party Or To A Candidate At A Federal Election |
| S1-F1-C1 | Medical Expense Tax Credit |
| S1-F1-C2 | Disability Tax Credit |
| S1-F1-C3 | Disability Supports Deduction |
| S1-F2-C1 | Education And Textbook Tax Credits |
| S1-F2-C2 | Tuition Tax Credit |
| S1-F2-C3 | Scholarships, Research Grants, And Other Education Assistance |
| S1-F4-C1 | Basic Personal And Dependant Tax Credits (For 2016 And Prior Years) |
| S1-F4-C2 | Basic Personal And Dependant Tax Credits (For 2017 And Subsequent Years) |
| S1-F5-C1 | Related Persons And Dealing At Arm's Length |
| S7-F1-C1 | Split-receipting and Deemed Fair Market Value |
| IT-113R4 | Benefits To Employees — Stock Options |
| IT-226R | Gift To A Charity Of A Residual Interest In Real Property Or An Equitable Interest In A Trust |
| IT-244R3 | Gifts By Individuals Of Life Insurance Policies As Charitable Donations |
| IT-407R4 | Dispositions Of Cultural Property To Designated Canadian Institutions |
| IT-523 | Order Of Provisions Applicable In Computing An Individual's Taxable Income And Tax Payable |

# Sample Tax Return And Tax Software SS Problem

The Chapter 4 Sample Tax Return and the Tax Software Self Study Problem for Chapter 4 can be found in the print and online Study Guide.

# Problems For Self Study (Online)

To provide practice in problem solving, there are Self Study and Supplementary Self Study problems available on MyLab Accounting.

Within the text we have provided an indication of when it would be appropriate to work each Self Study problem. The detailed solutions for Self Study problems can be found in the print and online Study Guide.

We provide the Supplementary Self Study problems for those who would like additional practice in problem solving. The detailed solutions for the Supplementary Self Study problems are available online, not in the Study Guide.

The .PDF file "Self Study Problems for Volume 1" on MyLab contains the following for Chapter 4:

- 8 Self Study problems,
- 3 Supplementary Self Study problems, and
- detailed solutions for the Supplementary Self Study problems.

# Assignment Problems

(The solutions for these problems are only available in the solutions manual that has been provided to your instructor.)

### *Assignment Problem Four - 1*

***(Personal Tax Credits - 5 Cases)***

In each of the following independent Cases, determine the maximum amount of 2019 personal tax credits, including transfers from a spouse or dependant, that can be applied against federal Tax Payable by the taxpayer. In all Cases, the taxpayer's Net Income For Tax Purposes is equal to their Taxable Income. Ignore, where relevant, the possibility of pension income splitting.

A calculation of Tax Payable is **NOT** required, only the applicable credits.

1. Cammy Tarbell has Net Income For Tax Purposes of $96,500, all of which is employment income. Her employer has withheld maximum EI and CPP contributions. She is married to Bob Tarbell who has Net Income For Tax Purposes of $8,650. They have four children ages 3, 5, 7, and 9. All of the children are in good health and none of them have any income during the current year.

2. Scotty Severa has been divorced for a number of years. Because his former wife is an airline pilot who travels extensively, he has been awarded custody of their three children. The children are aged 7, 10, and 15 and they are all in good health. Scotty's Net Income For Tax Purposes is $71,400, all of which is spousal support payments. The two younger children have no income of their own. The 15 year old has income from part time jobs of $8,640.

3. Donald Preble has Net Income For Tax Purposes of $126,325, all of which is rental income. His spouse Donna has Net Income For Tax Purposes $6,340. Their daughter Diane is 26 years old and has a mental disability. While the disability is not severe enough to qualify for the disability tax credit, she has no income during the current year and continues to live with Donald and Donna.

4. Bibi Spillman is 68 years old. Her Net Income For Tax Purposes totals $65,420 and is made up of OAS payments of $7,400 and pension income from a former employer. Her spouse is 62 years old and has Net Income For Tax Purposes of $6,250.

5. Clarice McBryde has Net Income For Tax Purposes of $132,400, all of which is employment income. Her employer has withheld the maximum EI and CPP contributions. She and her husband Moishe have two children aged 11 and 13. Moishe and the children have no income of their own during the current year.

   The 13 year old child was severely injured in a car accident two years ago and qualifies for the disability tax credit. No amount was paid for attendant care for this child during the current year.

   Clarice spent $12,500 installing wheelchair ramps to improve access to various parts of the family residence. She also spent the following on dental fees and fees for various medical practitioners:

| | |
|---|---|
| Clarice | $ 4,420 |
| Moishe | 2,620 |
| 11 Year Old Child | 1,875 |
| 13 Year Old Child | 14,250 |
| Total Medical Fees Paid | $23,165 |
| Reimbursement From Company Medical Plan<br>- Plan's Annual Maximum | ( 11,000) |
| Net Medical Fees Paid | $12,165 |

### Assignment Problem Four - 2

#### (Individual Tax Payable - 5 Cases)

Mr. William Norris is 45 years old. The following five independent Cases make varying assumptions for the 2019 taxation year with respect to Mr. Norris' marital status and number of dependants. In all Cases, Mr. Norris earned employment income of $60,000 and his employer withheld the required EI premiums and CPP contributions.

**Case A** Mr. Norris is married and his wife, Susan, has Net Income For Tax Purposes of $8,800. Susan's 73 year old mother, Bernice, lives with them. Bernice, has a mental infirmity that is not severe enough to qualify for the disability tax credit. However, it does make her dependent on William and Susan. Because of a large investment portfolio, Bernice had Net Income For Tax Purposes of $18,000 during 2019.

**Case B** Mr. Norris is married and his wife, Susan, has Net Income For Tax Purposes of $4,410. They have one child, Martha, who is 10 years of age. Martha had no income during the year. During the year, the family had medical expenses as follows:

| | |
|---|---|
| William | $1,200 |
| Susan | 1,600 |
| Martha | 350 |
| Total | $3,150 |

**Case C** Mr. Norris is married and his wife, Susan, has Net Income For Tax Purposes of $4,500. They have a son, Allen, who is 19 years old and lives at home. He attends university on a full time basis during 8 months of the year. Mr. Norris pays $9,000 for Allen's tuition and $900 for required textbooks. Allen had employment income during the summer months of $2,200. He will transfer any unused credits to his father.

**Case D** Mr. Norris is not married and has no dependants. On receipt of a $300,000 inheritance in December, he donates $50,000 to his local hospital, a registered charity. He chooses to claim $15,000 in 2019. He also makes contributions to a federal political party in the amount of $1,000.

**Case E** Mr. Norris is a single father. He has a daughter, Mary, who is 8 years old and lives with him. Two years ago, Mr. Norris graduated from a Canadian university. He currently has a Canada Student Loan outstanding. Mr. Norris pays back this loan in monthly instalments of $300. During the year, he paid $450 in interest on this loan.

**Required:** In each Case, calculate Mr. Norris' minimum federal Tax Payable for 2019. Indicate any carry forwards available to him and his dependants and the carry forward provisions. Ignore any tax amounts that Mr. Norris might have had withheld or paid in instalments.

## *Assignment Problem Four - 3*

### *(Individual Tax Payable - 7 Cases)*

The following seven independent Cases make varying assumptions with respect to Roger Blaine and his 2019 tax status. In all Cases, where Roger earned employment income, his employer withheld the maximum EI premium and CPP contribution.

**Case A** Roger Blaine is 48 years of age and has employment income of $65,000. During the year, Roger makes contributions to federal political parties in the amount of $1,000. Roger is not married and has no dependants.

**Case B** Roger Blaine is 48 years of age and has employment income of $65,000. His wife, Martha, is 43 years of age and has Net Income For Tax Purposes of $4,650. They have one child, Eileen, who is 11 years of age and has income of $3,000. During the year, the family had eligible medical expenses of $1,050 for Roger, $1,800 for Martha, and $300 for Eileen.

**Case C** Roger Blaine is 48 years old and his wife, Martha, is 43. Roger has rental income of $65,000 and Martha has investment income of $9,400. They have a 19 year old disabled son, Albert, who lives with them. His disability qualifies him for the disability tax credit and he has no income of his own. During the year, Roger and Martha have medical expenses of $1,250. Medical expenses for Albert during the year total $8,350.

**Case D** Roger Blaine is 48 years of age and his wife, Martha, is 43. They have no children. Roger has employment income of $65,000. Martha has employment income of $14,000. Martha's 68 year old father, Ahmed, and her 70 year old aunt, Jaleh, live with them. Both are in good health. Ahmed's Net Income For Tax Purposes is $9,200 and Jaleh's Net Income For Tax Purposes is $11,000. Roger paid $375 in interest related to his student loan during the year.

**Case E** Roger Blaine is 48 years of age and his common-law partner Bob is 43. Roger has employment income of $65,000. Bob has Net Income For Tax Purposes of $4,500. They have two adopted children, Barry aged 8 and Don aged 10. After living in rented premises for the last 7 years, Roger and Bob decide to purchase a residence. They acquire a 3 bedroom house in the suburbs at a cost of $245,000 and move into the house during the year.

**Case F** Roger Blaine is 48 years of age and his wife, Martha, is 43. Roger has employment income of $65,000. Martha has Net Income For Tax Purposes of $5,050. They have a son, Albert, who is 19 years old and lives at home. He attends university on a full time basis during 8 months of the year. Roger pays $5,400 for Albert's tuition for two semesters during the 2019 calendar year and $525 for required textbooks. Albert had employment income of $3,000 that he earned during the summer. He agrees to transfer the maximum of his tuition fee amount to his father.

**Case G** Roger Blaine is 67 and his wife Martha is 68. Martha has been completely disabled for a number of years and the extent of her disability qualifies her for the disability tax credit. Their son, Albert, is 38 years old, in good health and lives with them to help care for Martha. Albert has $10,000 of income from spousal support. The components of Roger and Martha's income are as follows:

| | Roger | Martha |
|---|---|---|
| Interest | $ 300 | $ 50 |
| Canada Pension Plan Benefits | 4,400 | 200 |
| Old Age Security Benefits | 7,400 | 7,400 |
| Income From Registered Pension Plan | 32,150 | 450 |
| Total Net Income | $44,250 | $8,100 |

**Required:** In each Case, calculate Roger Blaine's minimum federal Tax Payable for 2019. Indicate any carry forwards available to him and his dependants and the carry forward provisions. Ignore any amounts Roger might have had withheld or paid in instalments and the possibility of pension income splitting.

## *Assignment Problem Four - 4*

### *(Personal Tax Credits - 6 Cases)*

In each of the following independent Cases, determine the maximum amount of 2019 personal tax credits, including transfers from a spouse or dependant, that can be applied against federal Tax Payable by the taxpayer.

A calculation of Tax Payable is **NOT** required, only the applicable credits.

1. Ms. Jones is married and has Net Income For Tax Purposes of $123,000, none of which is employment income or income from self-employment. Her husband is currently unemployed, but has interest income from investments of $3,750. Her 20 year old dependent son attends university and lives at home. Her son has Net Income For Tax Purposes of $4,800 and does not agree to transfer his tuition credit to her.
2. Ms. Martin is 66 years old and has Net Income For Tax Purposes of $28,750. This total is made up of OAS of $7,400, plus pension income of $21,350 from a former employer. Her husband is 51 years old and blind. He has no income of his own. Ignore the possibility that Ms. Martin would split her pension income with her husband.
3. Mr. Sharp has Net Income For Tax Purposes of $72,350, none of which is employment income or income from self-employment. He lives with his common-law partner and her three children from a previous relationship. The children are aged 13, 15, and 20. The 20 year child is dependent because of a physical disability. However, the disability is not sufficiently severe to qualify for the disability tax credit. Neither the common-law partner nor any of the children have any source of income.
4. Mr. Barton was divorced two years ago and maintains a residence separate from his former spouse. He has custody of the three children of the marriage, aged 8, 9, and 10 and receives $2,500 per month in child support payments. Mr. Barton has Net Income For Tax Purposes of $62,300, none of which is employment income or income from self-employment. None of the children have any income of their own.

5. Ms. Cole has Net Income For Tax Purposes of $175,000, all of which is employment income. Her employer has withheld and remitted the required EI and CPP amounts. She was married on December 1, 2019. Her new husband is an accounting student with a large firm. His salary for the period January 1 through November 30, 2019 was $33,000. For the month of December, 2019, his salary was $3,000.

6. Mr. Smead has Net Income For Tax Purposes of $85,000, none of which is employment income or income from self-employment. He lives in a residence that he has owned for many years. He does not currently have a spouse or common-law partner. However, he has custody of his 10 year old son who lives with him. Also living with him is his 68 year old, widowed mother. She has a physical infirmity. However, it is not sufficiently severe for her to qualify for the disability tax credit. Mr. Smead's son had no income during the year. His mother had OAS benefits and pension income which totaled $18,500 during the year.

## Assignment Problem Four - 5

### (Comprehensive Tax Payable)

Ms. Tanja Umstead is 46 years old and lives in Richmond, British Columbia. She is in good health and works in the sales department of a large publicly traded company.

### Tanja's Personal Information

1. She is divorced from her husband and has custody of her 11 year old daughter, Cynthia. The daughter is sufficiently disabled that she qualifies for the disability tax credit. The daughter has 2019 Net Income For Tax Purposes of $6,425, largely made up of interest on bonds purchased from an inheritance.

2. Tanja's 68 year old mother lives with her and provides care for Cynthia on a full time basis. She is active and healthy. As she receives no compensation for this work, Tanja has no child care costs during 2019. The mother's 2019 Net Income For Tax Purposes is $13,460.

3. Because of a 2019 decrease in Cynthia's mobility, Tanja has had to install access ramps in several locations in her home. The cost of these ramps was $14,600.

4. During 2019, Tanja worked nearly 300 hours as a volunteer search and rescue volunteer. She received $200 in compensation for this work.

5. Tanja's 2019 medical expenses are as follows:

| | |
|---|---|
| Various Prescription Drugs Including Medical Marijuana (Tanja And Cynthia) | $ 3,465 |
| Various Medical Specialist Treatments For Cynthia | 10,490 |
| Prescription Sunglasses For Tanja And Cynthia | 875 |
| Liposuction For Tanja To Reduce Fat On Her Thighs | 2,463 |
| Dentist Fees For Tanja's Mother | 3,300 |
| Dentures For Tanja's Mother | 1,325 |

6. During 2019, Tanja contributes $3,500 to Unplanned Parenthood, a registered Canadian charity.

### Employment Information

1. Tanja's salary compensation for 2019 is $93,500. In addition, she was awarded a year-end bonus of $12,000, all of which is payable in January 2020.

2. Tanja's employer sponsors a defined benefit registered pension plan. During 2019, Tanja and her employer each contribute $4,150 to the plan. In addition, her employer withheld maximum EI contributions of $860 and maximum CPP contributions of $2,749.

3. Her employer offers to pay the tuition for employees taking foreign language courses. Tanja is taking an intensive course in spoken Chinese at a British Columbia university. The tuition fee for the course is $3,600, all of which is paid for by her employer. The tuition payment is to be included in her employment income as a taxable benefit. The duration of the course is 8 months and Tanja must purchase her own textbooks for $150.
4. Tanja is provided with disability insurance by an employer sponsored plan. During 2019, as a consequence of an automobile accident, she was unable to go to work for one month and receives benefits of $6,500. Starting in 2017, Tanja has been contributing $340 per year for the plan's coverage. Her employer makes a matching contribution in each year.
5. Tanja's employer provides her with an automobile that was purchased several years ago at a cost of $39,500. During 2019, the car is driven 41,000 kilometers, 34,000 of which were for employment related travel. Tanja is required to pay her own operating costs, which for 2019 totaled $7,240. Except for the one month that she was off from work, the car was available to Tanja throughout the year. During the one month that she was off, the car was left in her employer's garage.
6. Tanja's employer provides all of its employees with financial counseling services. The cost to the company of the services provided to Tanja was $450.
7. As a result of winning a sales contest, Tanja received a one week trip to Las Vegas. The value of this trip in Canadian dollars was $5,620.
8. Several years ago, Tanja received options to acquire 250 shares of her employer's common stock at a price of $25 per share. When the options were granted, the shares were trading at $25 per share. During 2019, Tanja exercises all of these options. On the exercise date, the shares are trading at $32 per share. Tanja is still holding the shares at the end of the year.

**Required:** Calculate, for the 2019 taxation year, Tanja's minimum Taxable Income and federal Tax Payable. Ignore GST and PST considerations.

## *Assignment Problem Four - 6*

### *(Comprehensive Tax Payable With Employment Income)*

Ms. Marcy Van Horne is employed by a large publicly traded corporation and her 2019 salary is $126,000. In addition to her annual salary, she received a performance bonus of $25,000, one-half of which was paid in 2019, with the remaining one-half not due until July 1, 2020. In addition to her salary, she earns commissions of $32,000 during 2019.

During 2019, Ms. Van Horne's employer withheld the following amounts from her compensation:

| | |
|---|---|
| EI Premiums | $ 860 |
| CPP Contributions | 2,749 |
| RPP Contributions | 7,400 |
| Life Insurance Premiums (Employer Makes A Matching Contribution) | 550 |

Ms. Van Horne is divorced and has custody of her two children. They are aged 12 and 17. The 12 year son has 2019 income of $2,500.

The 17 year old daughter is in full time attendance at a university during 8 months of the year. Ms. Van Horne pays her annual tuition of $7,000. The daughter has summer income of $4,500 and has agreed to transfer her education related credits to her mother. Also living with Ms. Van Horne is her 68 year old father whose Net Income For Tax Purposes for 2019 totals $8,000. He has supplemented his income for years with his casino winnings and they total $10,000 in 2019. While he does not qualify for the disability tax credit, he has a physical infirmity that makes him dependent on Marcy.

**Other Information:**

1. Ms. Van Horne is provided with an automobile by her employer. During 2019, it is driven 48,000 kilometres, of which 42,500 are employment related. The automobile is leased by the employer at a monthly rate of $728, including GST of $30 and PST of $48. The monthly rate also includes a payment for insurance of $50 per month. The automobile was used by Ms. Van Horne for 11 months during 2019. She was required to return the automobile to her employer's garage during the month that she did not use it.
2. Ms. Van Horne incurred the following employment related expenses during 2019:

| | |
|---|---|
| Advertising | $5,600 |
| Entertainment | 9,000 |
| Meals | 2,400 |
| Hotels | 8,400 |
| Airline Tickets | 3,400 |
| Total Expenses | $28,800 |

   Ms. Van Horne's employer reimburses all of her meal costs and one-half of her hotel bills. No other expenses were reimbursed.
3. During 2018, Ms. Van Horne was granted options to acquire 5,000 shares of her employer's common shares at an option price of $25 per share. This was also the market value of the shares at this time. During July, 2019, Ms. Van Horne exercises all of the options at a point in time when the shares were trading at $31 per share. She is still holding the shares at the end of the year.
4. During 2019, Ms. Van Horne gives total cash of $1,800 to a variety of registered charities.
5. Also during 2019, Ms. Van Horne donates $300 to each of the three federal political parties.
6. During 2019, Ms. Van Horne pays for the following eligible medical costs:

| | |
|---|---|
| For Herself | $ 850 |
| For Her Two Children | 1,480 |
| For Her Father | 3,940 |
| Total Medical Costs | $6,270 |

**Required:**

A. Determine Ms. Van Horne's minimum Net Income For Tax Purposes for the 2019 taxation year.

B. Determine Ms. Van Horne's minimum Taxable Income for the 2019 taxation year.

C. Based on your answer in Part B, determine Ms. Van Horne's federal Tax Payable for the 2019 taxation year. Indicate any carry forwards available to her and her dependants and the carry forward provisions. Ignore any amounts that might have been withheld by her employer or paid in instalments.

## *Assignment Problem Four - 7*

***(Comprehensive Tax Payable)***

Lydia Hines is a translator who works for a consulting firm in Ottawa. Her 2019 salary is $73,500, from which her employer, a Canadian controlled private company, deducts maximum CPP and EI contributions. Also deducted is an RPP contribution of $2,600. The employer makes a matching contribution. Her employment compensation does not include any commission income.

Lydia's husband, Mark is the beneficiary of a trust. Mark's mother was extremely wealthy and when she died, she left her assets to a trust for her children and her grandchildren. Mark will eventually inherit much of the estate. As a result, he no longer works for pay and devotes much of his time to volunteer work. His 2019 Net Income For Tax Purposes is $8,600. All of this income is from the trust.

The couple have three children aged 15, 20, and 22 who live with them. The 15 year old, Barry, is in good health and has 2019 Net Income For Tax Purposes of $9,400 from the trust.

The 20 year old, Mary, is dependent on her family because of mental health issues. However, she does not qualify for the disability tax credit. Her 2019 Net Income For Tax Purposes of $3,100 is from the trust.

The 22 year old, Harry, attends university on a full time basis in Vancouver for 8 months of the year. Lydia pays his tuition of $11,300, his textbook costs of $1,250 and his residence fees of $8,000. Harry's 2019 Net Income For Tax Purposes of $14,100 is from the trust. He has agreed to transfer the maximum tuition amount to Lydia.

**Other Information:**

1. To reward Lydia for her outstanding work, and as an incentive to stay with the company, her employer has awarded her a bonus of $10,000. Of this total, $4,000 will be paid in 2020, with the remaining $6,000 payable in 2023.

2. Lydia received options to purchase 200 shares of her employer's stock at a price of $72 per share last year. At the time the options were granted, the fair market value of the shares was $74 per share. During May, 2019, when the shares had a fair market value of $90 per share, Lydia exercises all of these options. She is still holding these shares at the end of the year.

3. Lydia is provided with an automobile by her employer. The automobile was leased on February 1, 2019 at a monthly rate of $565, a figure which includes a payment for insurance of $75 per month. The automobile is driven a total of 36,000 kilometers, 32,000 of which were employment related. It was available to her from February 1 to the end of the year. The employer did not provide an automobile during the month of January.

4. During 2019, Lydia spent $5,600 on employment related meals and entertainment with clients of her employer. Her employer reimbursed $3,200 of these costs.

5. During 2019, Lydia receives several gifts from her employer:

   - As is the case for all of the company's employees, Lydia receives a $150 gift certificate that can be used for merchandise at a local department store.
   - In recognition of her 10 years of service, Lydia receives a Visconti fountain pen she has been coveting. The retail value of this pen is $1,000.
   - At Christmas, all of the company's employees receive a gift basket of holiday treats. The retail value of these gift baskets is $200.

6. After years of accumulating savings and living in rental units, Lydia and Mark purchase a residence. The cost of the house is $380,000 and, to assist with the purchase, Lydia's employer provides a $100,000 interest free loan. The loan was granted on May 1, 2019 and will have to be repaid on April 30, 2024. Assume the prescribed rate is 2 percent throughout the year 2019.

7. Because of the nature of her employment, Lydia is required to pay annual professional dues of $350.

8. During 2019, Lydia makes her annual contribution of $2,000 to a registered charity, The No Hope Of Salvation Army. (Lydia is an atheist.)

9. Lydia's employer provides all employees with a health care plan. It reimburses employees for 50 percent of all prescriptions, dental and vision fees for the employee, the employee's spouse and all children under 18 years of age. The family's 2019 medical expenses, all of which were paid by Lydia, were as follows:

| | |
|---|---:|
| Lydia - Prescriptions | $2,500 |
| Lydia - Botox treatments | 1,400 |
| Mark - Dentist's fees for root canals (3) | 7,200 |
| Mark - Hair replacement procedures | 3,700 |
| Barry - Dentist's fees, including $1,000 for a tooth replacement | 2,100 |
| Mary - Doctor's fees for treatment for depression | 8,400 |
| Mary - Prescriptions | 3,900 |
| Mary - Liposuction treatment for her upper arms | 4,200 |
| Harry - Physiotherapy | 1,500 |
| Harry - Fees for prescription glasses and contact lenses | 2,200 |

**Required:**

A. Determine Lydia's minimum Net Income For Tax Purposes for the 2019 taxation year.

B. Determine Lydia's minimum Taxable Income for the 2019 taxation year.

C. Based on your answer in Part B, determine Lydia's federal Tax Payable for the 2019 taxation year.

## Assignment Problem Four - 8

### (Comprehensive Tax Payable)

Ezra Pinnock is 73 years old and is an engineering professor at a major Canadian University. He is in good health and lives in Toronto in a large house he inherited from his mother.

### Employment Information

1. Ezra's salary received for 2019 is $163,000. As the result of a negotiations by his union, he is entitled to receive an additional $8,000 in salary related to his work during 2019. However, this adjustment will not be received until January, 2020.

2. During 2019, Ezra's employer deducts EI contributions of $860. Because of his age and the fact that he is collecting CPP benefits, Ezra no longer has to make CPP contributions.

3. Ezra's employer sponsors a defined benefit pension plan. Because of his age, Ezra no longer contributes to this plan. However, when he reached age 69, he was required to start receiving a pension. During 2019, he received benefits from this plan of $26,000.

4. As much of Ezra's work involves distance education, he is required by his employer to maintain an office in his home. This home office occupies 18 percent of the space in his residence and is viewed as his principal place of business. The 2019 costs associated with this residence are as follows:

| | |
|---|---:|
| Electricity | $ 4,680 |
| Property Taxes | 19,200 |
| Interest On Mortgage | 12,000 |
| Insurance | 3,450 |
| Repairs To Roof | 4,970 |
| Lawn Maintenance | 863 |
| Snow Removal | 647 |
| Total | $45,810 |

5. As Ezra is one of his university's more charismatic professors, he does an extensive amount of travel promoting the university's programs. He receives an allowance of $1,000 per month ($12,000 in total) to cover his travel costs. The actual costs for 2019 are as follows:

| | |
|---|---|
| Hotels | $4,200 |
| Meals While Travelling | 1,650 |
| Airline Tickets | 2,150 |

In addition to these costs, Ezra uses his personal automobile for some of the travel. During 2019, the milage on the car totaled 32,000 kilometers, with 16,000 of these kilometers related to his travel for the university. Operating costs for the year totaled $3,200. His accountant has advised him that CCA for the year (100 percent basis) would be $4,500.

6. In 2019, having accumulated 10 years of service with his current employer, Ezra receives a cash award of $350 and a very fancy plaque. In addition, all of the university employees receive a basket of gourmet food at Christmas. The value of this basket is $325.

7. The university provides Ezra with $500,000 in life insurance coverage, as well as a supplemental accident and sickness insurance plan. The 2019 cost to the university for the life insurance coverage is $675, while the cost for the accident and sickness plan is $472. The accident and sickness plan would pay cash benefits due to injury or illness, it would not pay periodic benefits to replace salary if Ezra was unable to work. Ezra does not contribute to the accident and sickness plan.

8. After he was hit by a speeding bicyclist and injured, Ezra receives benefits under the accident and sickness plan of $1,245 during the year.

### *Other Income*

Having worked for several other universities prior to joining his present employer, Ezra has 2019 receipts from the registered pension plans sponsored by these universities of $35,000. In addition, he receives Canada Pension Plan benefits of $13,000. Since he knows his income will remain quite high for the foreseeable future, Ezra has not applied for OAS.

### *Personal Information*

1. Ezra has been married to Laurie Pinnock for over 40 years. Laurie is 64 years old and, because of a terrible skiing accident 3 years ago, she is sufficiently disabled that she qualifies for the disability tax credit. She has 2019 Net Income of $8,420 which includes $2,500 from a registered pension plan.

2. Ezra and Laurie have a 25 year old son named Martin. As the result of significant substance abuse, he continues to live at home. He is currently unemployed and his only income is $3,400 in employment insurance benefits.

3. Laurie's father Ezekial is 92 years old. Two years ago, on a senior's trip to Las Vegas, he met a retired pole dancer named Blaze. They hit it off immediately and Blaze returned to Canada with Ezekial. She is 77 years old and has established Canadian residency. They have both been living with Ezra and Laurie in the basement granny suite, presumably in a conjugal relationship, since that time. Ezekial has a physical infirmity and has income from various sources of $17,300. Blaze has no infirmity and no income in 2019. She is not eligible for OAS.

4. During 2019, Ezra spent $11,400 for home modifications required to deal with the mobility restrictions caused by Laurie's disability. Since Ezekial has very poor night vision, he also spent $1,200 on installing motion activated external lights for his safety.

5. During 2019, the family had medical expenses, all of which were paid for by Ezra, as follows:

| | |
|---|---|
| Ezra | $2,850 |
| Laurie | 3,420 |
| Martin | 2,470 |
| Ezekial | 685 |
| Blaze* | 1,432 |

*All of Blaze's expenses were for the reversal of a breast enhancement operation.

Although the spectacular results of her operation were very helpful to her career, she now feels the enhancement is not in keeping with her post-retirement lifestyle.

6. During 2019, Laurie wins $200,000 in a lottery. She donates cash of $50,000 to the Safe Skiing Research Fund, a registered Canadian charity. Laurie has been a regular donor since her accident.

**Required:** For the 2019 taxation year, calculate Ezra's minimum:

1. Net Income For Tax Purposes,
2. Taxable Income,
3. Federal Tax Owing.

In determining these amounts, ignore GST/HST considerations and the possibility of pension income splitting.

# Tax Software Assignment Problems

(The solutions for these problems are only available in the solutions manual that has been provided to your instructor.)

### *Tax Software Assignment Problem Four - 1*

**This problem is continued in Chapter 11.**

**DISCLAIMER:** All characters appearing in this problem are fictitious. Any resemblance to real persons, living or dead, is purely coincidental.

Mr. Buddy Musician (SIN 527-000-061) was born in Vancouver on August 28, 1951. He has spent most of his working life as a pianist and song writer. He and his family live at 111 WWW Street, Vancouver, B.C. V4H 3W4, phone (604) 111-1111.

Mr. Musician's wife, Natasha (SIN 527-000-129), was born on June 6, 1993. She and Mr. Musician have four children. Each child was born on April 1 of the following years, Linda; 2013, Larry; 2014, Donna; 2015, and Donald; 2016. Natasha's only income during 2018 is $3,000 from singing engagements.

Buddy and Natasha Musician have two adopted children. Richard (SIN 527-000-285) was born on March 15, 2001 and has income of $2,800 for the year. Due to his accelerated schooling, he started full time attendance at university in September of 2018 at the age of 17. His first semester tuition fee is $3,000 and he requires books with a total cost of $375. These amounts are paid by Mr. Musician.

The other adopted child, Sarah, was born on September 2, 1998, and is in full time attendance at university for all of 2018 (including a four month summer session). Her tuition is $9,600 and she requires textbooks which cost $750. These amounts are also paid by Mr. Musician. Sarah has no income during the year.

Neither Richard nor Sarah will have any income in the next three years. They both have agreed that the maximum tuition amount should be transferred to their father.

Mr. Musician's mother, Eunice, was born on April 10, 1931 and his father, Earl, was born on November 16, 1929. They both live with Mr. Musician and his wife. While his father has some mobility issues, he is not infirm. His mother is legally blind. Eunice Musician had income of $9,500 for the year, while Earl Musician had income of $7,500.

Other information concerning Mr. Musician and his family for 2018 is as follows:

*Tax Software Assignment Problems*

1. Mr. Musician earned $16,500 for work as the house pianist at the Loose Moose Pub. His T4 showed that his employer withheld $500 for income taxes and $293.90 for EI. No CPP was withheld as he has previously filed an election to stop contributing to the CPP.
2. During the year, Mr. Musician made his annual $3,000 donation to Planned Parenthood Of Canada, a registered Canadian charity.
3. Mr. Musician has been married before to Lori Musician (SIN 527-000-319). Lori is 52 years old and lives in Fort Erie, Ontario.
4. Mr. Musician has two additional children who live with their mother, Ms. Dolly Nurse (SIN 527-000-582), in Burnaby, British Columbia. The children are Megan Nurse, aged 12 and Andrew Nurse, aged 14. Neither child has any income during 2018. While Ms. Nurse and Mr. Musician were never married, Mr. Musician acknowledges that he is the father of both children. Although Buddy has provided limited financial aid by paying their dental and medical expenses, the children are not dependent on Buddy for support.
5. Mr. Musician wishes to claim all his medical expenses on a calendar year basis. On December 2, 2018, Mr. Musician paid dental expenses to Canada Wide Dental Clinics for the following individuals:

| | |
|---|---:|
| Himself | $1,200 |
| Natasha (wife) | 700 |
| Richard (adopted son) | 800 |
| Sarah (adopted daughter) | 300 |
| Linda (daughter) | 100 |
| Earl (father) | 1,050 |
| Lori (ex-wife) | 300 |
| Dolly Nurse (mother of two of his children) | 675 |
| Megan Nurse (daughter of Dolly Nurse) | 550 |
| Total | $5,675 |

6. Mr. Musician signed a contract with Fred Nesbitt on January 13, 2018 to do permanent modifications to his house. The contract was for the installation of ramps with sturdy hand railings outside his front and back doors to give his parents easier access to the house and modifications to their bathroom so they would be less likely to fall when using the shower. The contract price was $5,800. As neither of his parents has a severe and prolonged mobility impairment, these expenditures are not eligible medical expenses.
7. Mr. Musician paid four quarterly instalments of $1,000 each (total of $4,000) for 2018, as requested on his Instalment Reminders from the CRA. He paid each instalment on the due date.
8. Assume that Mr. Musician has not applied to receive either OAS or CPP benefits.

**Required**: With the objective of minimizing Mr. Musician's Tax Payable, prepare Mr. Musician's 2018 income tax return using the ProFile tax software program assuming Natasha does not file a tax return. List any assumptions you have made, and any notes and tax planning issues you feel should be placed in the file.

### *Tax Software Assignment Problem Four - 2*

**This problem is continued in Chapter 11.**

**DISCLAIMER:** All characters appearing in this problem are fictitious. Any resemblance to real persons, living or dead, is purely coincidental.

George Pharmacy is a pharmaceutical salesman who has been very successful at his job in the last few years. Unfortunately, his family life has not been very happy. Three years ago, his only child, Anna, was driving a car that was hit by a drunk driver. She and her husband were killed and their 14 year old son, Kevin, was blinded in the accident. He also suffered extensive injuries to his jaw that have required major and prolonged dental work.

George and his wife, Valerie, adopted Kevin. Valerie quit her part-time job to care for him. She also cares for her mother, Joan Drugstore who lives with them. Joan suffers from dementia, Parkinson's and severe depression. The family doctor has signed a letter stating that she is dependent on George and Valerie because of her impairments. Joan does not meet the residency requirements necessary to qualify for Canadian Old Age Security payments.

Valerie's parents separated two years ago in Scotland after her father, David Drugstore, suffered enormous losses in the stock market. They were forced to sell their home and David moved to Chile. David phones periodically to request that money be deposited in his on-line bank account.

George's brother, Martin, completed an alcohol rehabilitation program after being fired for drinking on the job. He is also living with George and Valerie while he is enrolled as a full time student at Western University. George is paying his tuition and Martin has agreed to transfer any available education related amounts to George. Although Martin plans to file his 2018 tax return, he has not done so yet.

Kevin is taking several undergraduate psychology courses at Western University. After hearing a talk given by an expert blind echolocator, i.e., one who uses sound to locate objects, his goal is to become a researcher at the Brain and Mind Institute and study the use of echolocation.

Other information concerning George for 2018 is given on the following pages.

**Required**: With the objective of minimizing George's Tax Payable, prepare the 2018 income tax return of George Pharmacy using the ProFile tax software program assuming Valerie does not file a tax return.

List any assumptions you have made, and any notes and tax planning issues you feel should be placed in the file. Ignore HST implications in your solution by assuming that George does not qualify for the GST/HST rebate.

| Personal Information | Taxpayer |
|---|---|
| Title | Mr. |
| First Name | George |
| Last Name | Pharmacy |
| SIN | 527-000-509 |
| Date of birth (Y/M/D) | 1954-07-02 |
| Marital Status | Married |
| Canadian citizen? | Yes |
| Provide information to Elections Canada? | Yes |
| Own foreign property of more than $100,000 Canadian? | No |

| Taxpayer's Address |
|---|
| 123 ZZZ Street, London, Ontario N0Z 0Z0 |
| Phone number (519) 111-1111 |

| Family Members | Spouse | Child | Mother-In-Law |
|---|---|---|---|
| First Name | Valerie | Kevin | Joan |
| Last Name | Pharmacy | Pharmacy | Drugstore |
| SIN | 527-000-483 | 527-000-517 | None |
| Date of birth (Y/M/D) | 1953-12-30 | 2002-10-17 | 1933-02-24 |
| Net income | $6,520 in CPP | Nil | $500 |

| Family Members | Father-In-Law | Brother |
|---|---|---|
| First Name | David | Martin |
| Last Name | Drugstore | Pharmacy |
| SIN | None | 527-000-533 |
| Date of birth (Y/M/D) | 1934-01-12 | 1971-06-02 |
| Net income | Nil | $8,300 |

During September, David was arrested in Chile. Valerie had to spend three weeks in Chile and pay $2,000 in bribes before she could get him released from jail. George had to pay Nannies On Call $3,500 for in-home help to take care of Kevin while she was gone.

| T2202A (Martin) | Box | Amount |
|---|---|---|
| Tuition fees - for Martin Pharmacy (brother) | A | 8,000 |
| Number of months in school - part-time | B | 0 |
| Number of months in school - full-time | C | 8 |

| T2202A (Kevin) | Box | Amount |
|---|---|---|
| Tuition fees - for Kevin | A | 3,600 |
| Number of months in school - part-time | B | 8 |
| Number of months in school - full-time | C | 0 |

| Donor | Charitable Donation Receipts | Am't |
|---|---|---|
| Valerie | Mothers Against Drunk Drivers (MADD) | 1,000 |
| George | Canadian Institute For The Blind (CNIB) | 3,000 |

| T4 | Box | Amount |
|---|---|---|
| Issuer - Mega Pharma Inc. | | |
| Employment income | 14 | 378,000.00 |
| Employee's CPP contributions | 16 | 2,593.80 |
| Employee's EI premiums | 18 | 858.22 |
| Income tax deducted | 22 | 114,000.00 |
| Employment commissions | 42 | 82,000.00 |
| Charitable donations | 46 | 400.00 |

During 2018, Mega reimbursed George $3,788 for meals and entertainment with clients, $2,268 for hotels and $4,925 for airline tickets.

In addition to George's salary, he also earns commissions. His employer requires him to have an office in his home and has signed the form T2200 each year to this effect.

On October 1, 2018, George purchased a new computer and software that will be used solely in his home office for employment related uses. The computer cost $3,600 and the various software programs cost $1,250.

| House Costs | |
|---|---|
| Area of home used for home office (square feet) | 650 |
| Total area of home (square feet) | 5,000 |
| Telephone line including high speed internet connection | 620 |
| Hydro | 3,200 |
| Insurance - House | 4,000 |
| Maintenance and repairs | 3,800 |
| Mortgage interest | 6,200 |
| Mortgage life insurance premiums | 400 |
| Property taxes | 6,700 |

| (Y/M/D) | Patient | Medical Expenses | Description | Am't |
|---|---|---|---|---|
| 2018-12-31 | George | Johnson Inc. | Out of Canada insurance | 731.00 |
| 2018-08-31 | George | Dr. Smith | Dental fees | 155.40 |
| 2018-09-19 | George | Optician | Prescription glasses | 109.00 |
| 2018-11-07 | Valerie | Pharmacy | Prescription | 66.84 |
| 2018-06-07 | Joan | Dr. Wong | Psychiatric counseling | 2,050.00 |
| 2018-03-22 | David | Tropical Disease Centre | Prescription | 390.00 |
| 2018-12-20 | Martin | Dr. Walker | Group therapy | 6,000.00 |
| 2018-10-01 | Kevin | Dr. Takarabe | Orthodontics and Dental | 30,000.00 |

George paid $800 for the care and feeding of Kevin's seeing eye dog, Isis, during 2018.

### *Tax Software Assignment Problem Four - 3*

**This problem is continued in Chapter 11.**

**DISCLAIMER:** All characters appearing in all versions of this problem are fictitious. Any resemblance to real persons, living or dead, is purely coincidental.

Seymour Career and Mary Career are your tax clients. They have been married for two years. Mary has progressed quickly in MoreCorp, the large, publicly traded firm she is working for due to her strong tax and accounting background. Her firm has an excellent health and dental plan that reimburses 100 percent of all medical and dental expenses.

Although Seymour has been working, his increasing ill health makes it likely that he will not be able to continue to work in 2019. He is contemplating a return to university as a student of music.

In order to estimate her possible financial position in 2019, she would like you to prepare her 2018 tax return assuming that Seymour has no income for 2018.

| Personal Information | Taxpayer | Spouse |
|---|---|---|
| Title | Ms. | Mr. |
| First Name | Mary | Seymour |
| Last Name | Career | Career |
| SIN | 527-000-129 | 527-000-079 |
| Date of birth (Y/M/D) | 1980-12-08 | 1959-01-29 |
| Marital status | Married | Married |
| Canadian citizen? | Yes | Yes |
| Provide information to Elections Canada? | Yes | Yes |
| Own foreign property of more than $100,000 Cdn? | No | No |

| Taxpayer's Address |
|---|
| 123 ABC Street, Saint John, N.B. E0E 0E0 |
| Phone number (506) 111-1111 |
| Spouse's address same as taxpayer? Yes |

| Dependant | Child |
|---|---|
| First Name | William |
| Last Name | Career |
| SIN | 527-000-319 |
| Date of Birth (Y/M/D) | 2011-02-24 |
| Net Income | Nil |

| T4 - Mary | Box | Amount |
|---|---|---|
| Issuer - MoreCorp | | |
| Employment Income | 14 | 152,866.08 |
| Employee's CPP Contributions | 16 | 2,593.80 |
| Employee's EI Premiums | 18 | 858.22 |
| RPP Contributions | 20 | Nil |
| Income Tax Deducted | 22 | 48,665.11 |
| Charitable Donations | 46 | 1,000.00 |

| Donor | Charitable Donation Receipts | Amount |
|---|---|---|
| Seymour | Canadian Cancer Foundation | 500 |
| Seymour | Salvation Army | 250 |

**Required**: With the objective of minimizing Mary's Tax Payable, prepare her 2018 income tax return using the ProFile tax software program. Assume that Seymour has no income in 2018 and that he does not file a tax return.

# CHAPTER 5

# Capital Cost Allowance

## Capital Cost Allowance System

### General Rules

5-1. In Chapter 6, we will give consideration to the calculation of business income as described in Subdivision b of the *Income Tax Act*. As was the case with employment income, business income is based on a group of inclusions and deductions that are combined to arrive at a net income or loss for the taxation year.

5-2. In Subdivision b, ITA 18(1) lays out a group of general limitations with respect to what can be deducted in the determination of net business income. In Paragraph 18(1)(b), it is noted that a taxpayer cannot deduct capital expenditures except as expressly permitted in the *Act*. In this same Subdivision b, ITA 20(1) provides a list of specific items that can be deducted in the determination of net business income. Paragraph 20(1)(a) notes that taxpayers can deduct such part of the capital cost of property "as is allowed by regulation". Taken together, these two Paragraphs provide the basis for the deduction of the tax equivalent of what financial accountants refer to as either depreciation or amortization. This tax "depreciation" is referred to as capital cost allowance (CCA).

5-3. While ITA 20(1)(a) provides the legislative basis for deducting CCA, all of the detailed rules for determining the amounts to be deducted are found in the *Income Tax Regulations* (ITR). More specifically, ITR Part XI lists the items to be included in the various CCA classes, while ITR Schedules II through VI provide the rates for each of these classes.

### Tax And Accounting Procedures Compared

#### *Introduction*

5-4. There are many similarities between the capital cost allowance system that is used for tax purposes and the amortization procedures that are used by financial accountants. In fact, the general goal of both sets of procedures is to allocate the cost of a depreciable asset to the expenses (deductions) of periods subsequent to its acquisition. However, there are a number of differences that are described in the material which follows.

#### *Terminology*

5-5. The two sets of procedures use different terms to describe items that are analogous. While the amounts involved will be different, the underlying concepts are the same. For example, both Undepreciated Capital Cost (UCC) and Net Book Value refer to the original

**Figure 5 - 1**
**Comparison Of Accounting And Tax Terminology**

| Taxation Term | | Accounting Term |
|---|---|---|
| Capital Cost | ⟷ | Acquisition Cost |
| Capital Cost Allowance (CCA) | ⟷ | Amortization Or Depreciation Expense* |
| Undepreciated Capital Cost (UCC) | ⟷ | Net Book Value (NBV) |

*While these two terms are used interchangeably in most tax literature, for accounting purposes, their use is more prescribed. In the *Handbook* for Canadian private enterprises, the term depreciation is not used. The write off of all types of business assets is consistently referred to as amortization.

In contrast, under International Financial Reporting Standards, the term depreciation is used for tangible business assets and the term amortization is reserved for intangible business assets.

Both terms are used in tax literature without being attached to particular types of assets. This is the approach that is used in this text.

cost of a depreciable asset, less amounts that have been deducted in the calculation of income. A general comparison of these analogous terms is found in Figure 5-1.

5-6. However, one technical difference in the use of the terms is that where Net Book Value at the end of the year is reduced by the amortization expense for the year, UCC is reduced by CCA deducted in preceding years only. In other words, the December 31, 2019 UCC is not reduced by the 2019 CCA. The 2019 CCA is deducted in the calculation of the January 1, 2020 UCC.

5-7. With respect to dispositions of depreciable assets, the accounting and tax procedures are very different and, as a result, the related terminology cannot be directly compared. For accounting purposes, a disposition will simply result in a gain or loss. For tax purposes, a disposition could result in no tax effect, a capital gain and recapture of CCA, recapture of CCA only, or a terminal loss. There is no real equivalency between these two sets of terminology.

## Acquisitions

5-8. The accounting and tax procedures for acquisitions can be described as follows:

**Accounting** In general, accountants record an acquisition cost for each material asset acquired. The acquisition cost that will be recorded in individual asset records is the amount of consideration given up to acquire the asset. This would include all costs directly attributable to the acquisition, including installing it at the relevant location and in the condition necessary for its intended use.

**Tax** In general, the capital cost of acquired assets will be allocated to what is referred to as a class. These classes are, in most cases, broadly defined (e.g., Class 10 contains most types of vehicles acquired by an enterprise).

In general, the amount of capital cost to be recorded is the same number that would be recorded as the acquisition cost in the accounting records. A difference can arise, however, when non-arm's length transactions are involved. In accounting, the acquired asset will consistently be recorded at the fair value of the consideration given up. This is not always the case when tax procedures are applied to non-arm's length transactions. This will be discussed in Chapter 9, Other Income, Other Deductions and Other Issues.

In general, there is no need to keep track of individual assets for purposes of calculating CCA. However, the procedures applicable to dispositions require that we know

the capital cost of each individual asset. Given this, it will be necessary, in the tax records, to track this information.

## Dispositions

5-9. The accounting and tax procedures for dispositions can be described as follows:

**Accounting** For accounting purposes, the Net Book Value of the asset disposed of is subtracted from the proceeds from that disposition. If the result is positive, a gain is recorded. Alternatively, if the result is negative, a loss is recorded. For a disposition to result in no income item for accounting purposes, the proceeds of disposition would have to be equal to the net book value of the individual asset. This would be a fairly rare event.

**Tax** Tax procedures require that the lesser of the proceeds of disposition and the capital cost of the specific asset be deducted from the UCC balance of its class. While this procedure will often have no tax consequences in the current year (other than decreasing future CCA), there are several other possibilities. There may be a capital gain, a capital gain and recapture of CCA, recapture of CCA only, or a terminal loss. These more complex concepts will be explained at a later point in this Chapter. As noted, while CCA calculations are based on classes of assets, to deal with the disposition of assets, the capital cost of each individual asset must be available.

## Amortization And Capital Cost Allowance

5-10. The accounting and tax procedures for allocating the cost of depreciable assets to income can be described as follows:

**Accounting** Accounting amortization is based on the consistent application of generally accepted accounting principles (GAAP). While these principles would encompass a wide variety of methods, including those used for calculating the maximum CCA for tax purposes, the straight-line method is by far the most widely used method for accounting purposes.

Once a method is chosen, it is generally applied to individual assets. The adopted method must be applied consistently, with the full amount that results from its application being charged as an expense in the determination of accounting Net Income for the current period.

**Tax** The *Income Tax Regulations* specify the method that must be applied to each class. Two methods are used for this purpose — the straight-line method and the declining balance method. The required method will be applied to calculate a maximum deduction for the taxation year.

While taxpayers will usually wish to deduct this maximum amount, they are not required to do so. They can deduct all of the maximum amount, none of it, or any value in between. While the regulations specify consistency in the calculation method used, there is no requirement for year-to-year consistency in the portion of the maximum amount deducted. This is in sharp contrast to the accounting requirement that the full amount of amortization be deducted in each year.

A further difference is that, for tax calculations, there are special rules applicable to the first year that an asset is available for use. The so-called half-year rules have been applicable to newly acquired assets for many years. New for this edition are the provisions for the Accelerated Investment Incentive (AccII). As we shall see later in this Chapter 5, these provisions add significant complexity to the calculation of CCA for the first year of an asset's use.

5-11. As previously noted, most companies use straight-line amortization for accounting purposes. In contrast, the *Income Tax Regulations* require the use of declining balance procedures on the majority of important CCA classes. Given that the declining balance method provides a faster write off than the straight-line method, and the fact that most enterprises will deduct the maximum amount of CCA under this method, the amount of CCA deducted is

usually larger than the amount of accounting amortization charged to expense. Because of this, most companies will have accounting values for their depreciable assets that are significantly larger than the corresponding tax values. These differences are referred to as temporary differences and, as many of you are aware, GAAP requires the recording of a Future Income Tax Liability to reflect such differences.

# Additions To Capital Cost

## Determination Of Amounts

### General Rules

5-12. To be added to a CCA class, an asset must be owned by the taxpayer and, in addition, it must be used for the purpose of producing income from business, property, or in certain limited circumstances, employment. Stated alternatively, the asset must be a capital asset rather than inventory. This means that whether an asset should be added to a CCA class depends on the nature of the business. A drill press is a capital asset for a taxpayer using it in a manufacturing process. However, it would be treated as inventory by a taxpayer in the business of selling that type of equipment.

5-13. Capital cost means the full cost to the taxpayer of acquiring the property and would include all freight, installation costs, duties, non-refundable provincial sales taxes, legal, accounting, appraisal, engineering, or other fees incurred to acquire the property. Note that any refundable GST or HST would not be added to the capital cost (see Paragraph 5-21).

5-14. In the case of property constructed by the taxpayer for use in producing income, it would include material, labour, and an appropriate allocation of overhead. If the property is paid for in a foreign currency, the Canadian dollar capital cost would be determined using the exchange rate on the date of acquisition.

### Capitalization Of Interest

5-15. In addition to the direct costs described in Paragraphs 5-13 and 5-14, ITA 21(1) allows a taxpayer to elect to add the cost of money borrowed to acquire depreciable property to its capital cost. This election is in lieu of deducting the interest in the current taxation year and will usually be an undesirable choice.

5-16. However, if the deduction of the interest in the current year would result in a non-capital loss, this election may be desirable. By adding the interest to the capital cost of the asset, the amount can be deducted as part of the CCA on the asset's class for an unlimited number of future years. Alternatively, if it serves to increase the non-capital loss for the year, it would become part of the loss carry forward or loss carry back for the year. It would then be subject to the business and property loss carry over time limits of 3 years back and 20 years forward.

### Government Assistance

5-17. Another consideration in determining the capital cost of an addition to a CCA class is government assistance. Under ITA 13(7.1), any amounts received or receivable from any level of government for the purpose of acquiring depreciable assets must be deducted from the capital cost of those assets. This would include grants, subsidies, forgivable loans, tax deductions, and investment tax credits.

5-18. This tax requirement is consistent with the requirements of IAS 20, *Accounting For Government Grants And Disclosure Of Government Assistance*, which, in general, requires government assistance, including investment tax credits, to be deducted from the cost of assets for accounting purposes.

### Non-Arm's Length Acquisitions

5-19. If transfers of depreciable property between persons not dealing at arm's length are not made at fair market value or as a gift, they are subject to very unfavourable tax treatment. This may result in the capital cost of the asset not being equal to the amount of consideration given for the asset. This point is discussed in more detail in Chapter 9.

### GST, HST And PST Considerations

5-20. GST, PST (Provincial Sales Tax), or HST (Harmonized Sales Tax) is usually paid on depreciable asset acquisitions. While we will not provide detailed coverage of GST/HST until Chapter 21, you should be aware of the following:

- GST paid by businesses on the acquisition of assets will, in general, be refunded as input tax credits. Note that there are many complications related to this rule and they will be discussed in Chapter 21.
- HST is the term used to refer to the combined GST and PST amounts that are collected in Ontario and all of the Atlantic provinces. In general, HST paid on the acquisition of depreciable assets is refunded as input tax credits.
- The Quebec PST is integrated with the GST system and, as a consequence, these amounts are refunded on much the same basis as GST.
- The PST that is paid in other provinces, such as Manitoba and British Columbia, is not refunded and, as a consequence, it is included in the capital cost of acquired assets.

5-21. From a technical point of view, all amounts of GST/HST/PST are, at least initially, included in the capital cost of depreciable assets. However, to the extent that these amounts are refunded as input tax credits, they are defined in ITA 248(16) as a form of government assistance and, as a consequence, the refunds are deducted from the capital cost of depreciable assets in the same manner as other government assistance. In somewhat simplified terms, GST/HST/PST amounts that are refunded are not included in the capital cost of depreciable assets.

**EXAMPLE** An enterprise acquires a depreciable asset in Manitoba at a cost of $11,200. The cost is determined as follows:

| | |
|---|---:|
| Capital Cost Before Tax | $10,000 |
| Federal GST At 5 Percent | 500 |
| Manitoba's 7 Percent Provincial Retail Sales Tax | 700 |
| Total Cost | $11,200 |

**ANALYSIS** Provided the enterprise is a GST registrant and the asset is used in delivering GST taxable supplies, the $500 federal GST will be refunded as an input tax credit. However, there will be no refund of the $700 paid to Manitoba. This means that the CCA base for this asset is the amount of $10,700 ($10,000 + $700).

### Expenditures On Assets - Expense Or Improvement?

5-22. When a business owns assets with extended useful lives (e.g., buildings or certain types of machinery), it is likely that, over the lives of these types of assets, the enterprise will incur additional costs. When this occurs, a question arises as to whether the costs should be added to the capital cost of the asset or, alternatively, deducted as a current expense.

5-23. Unfortunately, there is no simple answer to this question, resulting in relatively frequent conflicts between the CRA and the taxpayer making such expenditures. To avoid such conflicts, the CRA's website provides some criteria to be used in making such decisions. Although the web page relates to rental income, the criteria are generally applicable and are as follows:

1. Does the expense provide a lasting benefit?
    - The CRA notes that painting the exterior of a wooden building would not provide a lasting benefit and should be charged to current expense.
    - In contrast, putting vinyl or metal siding on a wooden building would be a lasting improvement and should be added to the capital cost of the building.
2. Does the expense maintain or improve the property?
    - If a business repairs an existing set of wooden steps, the repair costs would be viewed as a current expense.

- In contrast, if the wooden steps are replaced with concrete steps, this would improve the property and should be added to the capital cost of the property.

3. Is the expense for a part of the property or is it a separate asset?
    - The CRA notes that the replacement of existing wiring in a building would normally be an expense, provided it does not improve the property.
    - In contrast, buying a compressor for use in a business would be treated as a separate addition to the appropriate class.

5-24. If a decision cannot be made on the basis of the three preceding factors, the CRA notes that the amount of the expenditure relative to the value of the property should be considered. If the expenditure is large relative to the value of the property, this would suggest that it should be added to the capital cost, rather than treated as an expense. The CRA also notes that the question of whether an expenditure improves the market value of an asset is not a relevant consideration in this matter.

### Summary

5-25. In reviewing the detailed tax rules applicable to depreciable asset acquisitions, it is clear that these rules will produce capital costs for depreciable assets that are almost always identical to the acquisition costs produced when GAAP is applied. While differences between amortization amounts and the corresponding CCA deductions will cause these values to diverge significantly as the assets are used, the initial amounts recorded for depreciable assets will normally be the same for both accounting and tax purposes.

## Available For Use Rules

5-26. For many types of assets, the available for use rules do not present a problem. Most acquired assets are put into use immediately and the acquirer is allowed to deduct CCA in the year of acquisition. For other assets, the rules can make CCA calculations quite complicated. Real estate assets, especially those that require several years to develop, can be particularly hard hit by the fact that there can be a deferral of the right to deduct CCA for two years, or until the structure is considered available for its income producing use.

5-27. The basic rules are found in ITA 13(26) through 13(32). In simplified terms, properties are considered to be available for use, and thereby eligible for CCA deductions, at the earliest of the following times:

- For properties other than buildings, when the property is first used by the taxpayer for the purpose of earning income.
- For buildings, including rental buildings, when substantially all (usually 90% or more) of the building is used for the purpose for which it was acquired.
- The second taxation year after the year in which the property is acquired. This maximum two year deferral rule is also referred to as the rolling start rule.
- For public companies, the year in which amortization is first recorded on the property under generally accepted accounting principles.
- In the case of motor vehicles and other transport equipment that require certificates or licences, when such certificates or licences are obtained.

5-28. The preceding is a very incomplete description of the available for use rules. There are other special rules for particular assets, as well as significant complications in the area of rental properties. Detailed coverage of these rules goes beyond the scope of this text.

## Segregation Into Classes

### General Rules

5-29. Part XI and Schedules II through VI of the *Income Tax Regulations* provide a detailed listing of classes and rates for the determination of CCA. There are over 40 classes that vary from extremely narrow (Class 26 which contains only property that is a catalyst or deuterium enriched water) to extremely broad (Class 8 refers to property that is a tangible capital asset and not included in another class). As the applicable rates vary from a low of 4 percent to a

high of 100 percent, the appropriate classification can have a significant impact on the amount of CCA that can be taken in future years. This, in turn, has an impact on Taxable Income and Tax Payable.

5-30. In general, assets do not belong in a class unless they are specifically included in the ITR description of that class. While there are a large number of classes and, as we have noted, Class 8 contains a provision for tangible property not listed elsewhere, some assets are specifically excluded from depreciable property status by ITR 1102. Most importantly, inventories and land cannot be added to any CCA Class. This means, in dealing with real property, the land component of the total cost must be separated from the building component.

5-31. For your convenience in working with CCA problems, the Appendix to this Chapter provides an alphabetical list of common assets, indicating the appropriate CCA class as well as the rate applicable to that class.

## *Separate Classes*

5-32. The general rule is that all of the assets that belong in a particular class are allocated to that class, resulting in a single class containing all of the assets of a particular type. There are, however, a number of exceptions to this general rule that are specified in ITR 1101. Some of these exceptions, for instance the requirement of a separate Class 30 for each telecommunication spacecraft, are not of general importance. However, some of the other exceptions are applicable to a large number of taxpayers. These important exceptions are as follows:

**Separate Businesses** An individual may be involved in more than one unincorporated business. While the income of all of these businesses will be reported in the tax return of the individual, separate CCA classes will have to be maintained for each business. For example, an individual might own both an accounting practice and a coin laundry. Both of these unincorporated businesses would likely have Class 8 assets. However, a separate Class 8 would have to be maintained for each business. In contrast, if an individual owned three separate shopping malls, these could be viewed as a single business and, as a consequence, have combined classes for the three operations. Note, however, that if each mall was incorporated separately, the group could not be viewed as a single business.

**Rental Properties** Of particular significance in the tax planning process is the requirement that each rental property acquired after 1971 at a cost of $50,000 or more be placed in a separate CCA class. When the property is sold, the lesser of the proceeds of disposition and the cost of the asset will be removed from the particular class. This will commonly result in a negative balance in the class and this amount will have to be taken into income by the taxpayer (see later discussion of recapture of CCA). If it were not for the separate class requirement, this result could be avoided by adding other properties to a single rental property class. The implications of this rule are discussed more extensively in Chapter 7 which deals with property income.

**Luxury Cars** The separate class rules apply to passenger vehicles that have a cost in excess of a prescribed amount. While this prescribed amount was expected to be changed periodically, it has been $30,000 from 2001 through 2019.

**Elections** For the assets described in the preceding three paragraphs, separate classes must be used. The taxpayer has no choice in the matter. There are other situations where a taxpayer is allowed to elect having a separate class. One of these situations involves non-residential buildings where the election to use a separate class can result in an additional amount of CCA (see Paragraph 5-36). Another situation involves assets subject to high rates of technological obsolescence (e.g., photocopiers). In this case a separate class election can provide for the recognition of terminal losses. This election is discussed later in this Chapter.

# Capital Cost Allowances

## General Overview

### Methods

5-33. Once capital assets have been allocated to appropriate classes, these amounts form the base for the calculation of CCA. The maximum CCA is determined by applying a rate that is specified in the Regulations to either the original capital cost of the assets in the class (straight-line classes) or, more commonly, to the end of the period UCC for the class (declining balance classes). The following example will illustrate this difference:

**EXAMPLE** A particular CCA class contains assets with a capital cost of $780,000 and a beginning of the period UCC balance of $460,000. There have been no additions to the class during the year. The rate for the class is 10 percent.

**Declining Balance Class** If we assume that this is a declining balance class, the rate would be applied to the $460,000 beginning of the period UCC balance. This would result in a maximum CCA for this class of $46,000 [(10%)($460,000)].

**Straight-Line Class** If we assume that this is a straight-line class, the rate would be applied to the $780,000 original cost of the assets. This would result in a maximum CCA for this class of $78,000 [(10%)($780,000)].

5-34. This basic process is fairly simple and straightforward. However, it is complicated by a number of other considerations.

**Half-Year (a.k.a. First Year) Rules** Prior to the November 21, 2018 economic statement, this rule applied to the majority of CCA calculations. It required that one-half of any excess of additions for acquisitions, over deductions for dispositions to a class for the year, must be subtracted prior to the application of the appropriate CCA rate. While an equivalent rule is still applicable to some acquisitions, for most depreciable assets, the new Accelerated Investment Incentive (AccII) is applicable.

**Accelerated Investment Incentive (AccII)** On November 21, 2018, the federal government announced provisions that would significantly increase the amount of CCA that could be deducted in the first year that most capital assets become available for use. While these new provisions do not change the total amount of CCA that will be available for a given asset, they are intended to encourage investment in capital assets by speeding up the rate at which their cost can be deducted. Detailed consideration will be given to these provisions later in this Chapter 5.

**Short Fiscal Periods** There are several situations in which a business will have a short fiscal period (e.g., a new unincorporated business that starts in July and has a December 31 year end). In these situations, maximum CCA must be reduced to an appropriate fraction of a full year.

5-35. Each of these complications will be given separate treatment in this section on the calculation of CCA. A further complication arises from the fact that, in general, taxpayers are not permitted to create or increase a net rental loss by claiming CCA on rental properties. Coverage of this topic will be deferred until Chapter 7 where we give detailed attention to the issues related to the taxation of property income.

## Rates For Commonly Used CCA Classes

5-36. The following is a brief description of the more commonly used CCA classes, including the items to be added, the applicable rates, and the method to be used. We would note that almost all of our examples and problem material will use only the CCA Classes that are described here.

**Class 1 - Buildings (4%, 6%, or 10%)** In general, Class 1 is a 4 percent declining balance class, applicable to buildings acquired after 1987. This class also includes bridges, canals, culverts, subways, tunnels, and certain railway roadbeds.

Each rental building with a cost of $50,000 or more must be allocated to a separate Class 1.

The purchaser of a new non-residential building acquired after 2007 can elect to allocate it to a separate Class 1 and the general 4 percent rate is increased as follows:

- to 10 percent if it is used 90 percent or more for manufacturing and processing,
- to 6 percent if it does not qualify for the manufacturing and processing rate, but is used 90 percent or more for non-residential purposes.

Note that these enhanced rates apply only to new buildings that have not been used or acquired for use before March 19, 2007, and that have been allocated to a separate Class 1.

**Class 3 - Buildings Pre-1988 (5%)** Class 3 is a 5 percent declining balance class. It contains most buildings acquired before 1988. As is the case for Class 1 rental properties, separate classes were required for each rental building with a cost of $50,000 or more. This class also includes breakwaters, docks, trestles, windmills, wharfs, jetties, and telephone poles.

**Class 8 - Various Machinery, Equipment, and Furniture (20%)** Class 8 is a 20 percent declining balance class. It includes most machinery, equipment, structures such as kilns, tanks and vats, electrical generating equipment, advertising posters, bulletin boards, and furniture not specifically included in another class. As will be discussed at a later point in the Chapter, individual photocopiers, fax machines, and pieces of telephone equipment purchased for $1,000 or more can be allocated to a separate Class 8 at the election of the taxpayer.

**Class 10 - Vehicles (30%)** Class 10 is a 30 percent declining balance class. It includes most vehicles (excluding certain passenger vehicles that are allocated to Class 10.1), automotive equipment, trailers, wagons, contractors' movable equipment, mine railway equipment, various mining and logging equipment, and TV channel converters and decoders acquired by a cable distribution system.

Note that after March 19, 2019, zero emission vehicles that would normally be allocated to this Class are allocated to Class 54, a Class which provides a 100 percent write off in the year of acquisition.

**Class 10.1 - Luxury Cars (30%)** Class 10.1 is a class established for passenger vehicles with a cost in excess of an amount prescribed in ITR 7307(1)(b). For cars acquired in 2001 through 2019, the prescribed amount is $30,000. Like Class 10, where most other vehicles remain, it is a 30 percent declining balance class. However, each vehicle must be allocated to a separate Class 10.1. Also important is that the amount of the addition to the separate class is limited to the prescribed amount of $30,000. This, in turn, limits the base for CCA to this same amount.

On the positive side, in the year in which the vehicle is retired, one-half of the normal CCA for the year can be deducted, despite the fact that there will be no balance in the class at the end of the year. A further difference from the regular Class 10 is that, in the year of retirement, neither recapture nor terminal losses are recognized for tax purposes.

As was the case with Class 10 Vehicles, zero emission vehicles that would normally be allocated to this Class are allocated to Class 54, a Class which provides a 100 percent write off in the year of acquisition.

**Class 12 - Computer Software and Small Assets (100%)** Class 12 includes computer software that is not systems software, books in a lending library, dishes, cutlery, jigs, dies, patterns, uniforms and costumes, linen, motion picture films, and videotapes. Dental and medical instruments, kitchen utensils, and tools are included, provided they cost less than $500. This class is subject to a 100 percent write-off in the year of acquisition.

**Class 13 - Leasehold Improvements (Straight-Line)** In general, only assets that are owned by the taxpayer are eligible for CCA deductions. However, an exception to this is leasehold improvements which are allocated to Class 13. For Class 13, the Regulations specify that CCA must be calculated on a straight-line basis for each capital expenditure incurred. The maximum deduction will be the lesser of:

- one-fifth of the capital cost of the improvement; and
- the capital cost of the lease improvement, divided by the lease term (including the first renewal option, if any).

The lease term is calculated by taking the number of full 12 month periods from the beginning of the taxation year in which the particular leasehold improvement is made until the termination of the lease. For purposes of this calculation, the lease term is limited to 40 years.

**Class 14 - Limited Life Intangible Assets (Straight-Line)** Class 14 covers the cost of intangible assets with a limited life. These assets are subject to straight-line amortization over their legal life. IT-477 indicates that CCA should be calculated on a pro rata per diem basis. In both the first and last years of the asset's life, the per diem approach would be used. Note, however, if there is a disposition of Class 14 assets, the usual recapture and terminal loss procedures would apply.

**Class 14.1 - Goodwill And Other Intangible Assets** Class 14.1 did not exist prior to January 1, 2017. The rate for any post-2016 additions to this Class is 5 percent applied to a declining balance. In general terms, the items that are added to this Class 14.1 are:

- Goodwill.
- Intangible assets that do not belong in any other Class. While this is something of a simplification, this category will largely be intangible assets that do not have a limited life. Intangible assets with limited lives are allocated to Class 14 or 44.
- Amounts included in Cumulative Eligible Capital (CEC) balances that were present on December 31, 2016. See later discussion of transitional rules.

There are a number of complications associated with this Class, including the fact that old CEC balances were transferred into this Class. Given this, we will provide a more extensive discussion of Class 14.1 beginning at Paragraph 5-71.

**Class 44 - Patents (25%)** At one point in time, patents were allocated to Class 14 where they were amortized over their legal life of 20 years. This approach failed to recognize that the economic life of this type of asset was usually a much shorter period. To correct this problem, patents are now allocated to Class 44, where they are subject to write-off at a 25 percent declining balance rate. Note, however, that a taxpayer can elect to have these assets allocated to Class 14. This would be a useful alternative if a patent was acquired near the end of its legal life. For example, if a patent only had two years remaining in its legal life, allocating its acquisition to Class 14 would result in the business being able to write off the asset over two years at a 50 percent rate.

**Class 50 - Computer Hardware And Systems Software (55%)** For computer hardware and systems software acquired after January 31, 2011, the required allocation is to Class 50. CCA on this Class is calculated on a declining balance basis, using a 55 percent rate.

The CRA has issued an interpretation that iPhones are "general purpose electronic data processing equipment", i.e., Class 50 assets. Although there is no specific reference to them, it would be logical to assume that tablets and other smartphones would also qualify. Basic cell phones (that are not smart enough to be smartphones) would be Class 8 assets as they are communications equipment.

If an expenditure of this type had a short life that is expected to be less than a year, e.g., a disposable cell phone, it would not normally meet the definition of capital property and would be considered a current expense, not a depreciable capital asset.

**Classes 53, 29 and 43 - Manufacturing and Processing Assets** The situation here has been complicated by changes in the designated class for manufacturing and processing assets. Unfortunately, at this point in time, there may be balances in all of the classes that have been used. The relevant information is as follows:

- **Class 53** Beginning in 2016, manufacturing and processing assets are allocated to Class 53. This Class has a 50 percent rate applied to a declining balance.
- **Class 29** This Class applied to assets acquired before 2016. It was a 50 percent straight-line Class and, while there may be some Class 29 balances remaining, such balances would be unusual. Given this, we will not include any Class 29 calculations in our examples or problems.
- **Class 43** Manufacturing and processing assets acquired before March 19, 2007 are included in Class 43 where the rate is 30 percent applied to a declining balance. As this is a declining balance class, there will be balances in this Class for many years to come.

This treatment of manufacturing and processing assets illustrates the procedures often used when the federal government wishes to change the rate applicable to certain types of assets. While they could accomplish this by simply changing the rate applicable to the relevant Class, this would, in effect, change the rules for asset purchase decisions made in previous years.

Given this, they normally implement a decision to change rates by allocating newly acquired assets to a new or different class. This means that the new rate is only applicable to new asset acquisitions. This does, however, complicate matters in that the same type of asset may be found in more than one class, depending on when it was acquired. This is illustrated here where it would be possible to have the same type of equipment found in three different CCA classes and subject to three different calculations.

**Class 54** This is a temporary Class created by the March 19, 2019 federal budget. It contains zero emission vehicles that otherwise would be included in either Class 10 or Class 10.1. Vehicles allocated to this Class are eligible for a 100 percent write off in their year of acquisition. This Class will be discussed in more detail beginning at Paragraph 5-61.

**Class 55** This is a temporary Class created by the March 19, 2019 federal budget. It contains zero emission vehicles that otherwise would be included in Class 16, such as taxis and vehicles used in a daily car rental business. Class 16 is a fairly specialized Class that is not given much coverage in this text and, reflecting this, little attention will be given to Class 55.

## Exercise Five - 1

**Subject:** Segregation Into CCA Classes

For each of the following depreciable assets, indicate the appropriate CCA Class. (The Appendix to this Chapter contains a listing of CCA classes.)

- Taxicab (gas powered)
- Manufacturing and processing equipment acquired in 2019
- Franchise with a limited life
- Automobile (i.e., passenger vehicle) with a cost of $120,000 (gas powered)
- Government licence with an unlimited life acquired in 2019
- Water storage tank

- Photocopy machine
- Leasehold improvements
- Residential rental property acquired for $200,000. The purchase price was allocated $150,000 to the building and $50,000 to the land.

## Exercise Five - 2

**Subject:** CCA Error

During the taxation year ending December 31, 2019, your company acquired a depreciable asset for $326,000 and you included this asset in Class 1 for the year (it was not allocated to a separate Class 1). Early in 2020, you discover that the asset should have been allocated to Class 10. What was the impact of this error on your company's 2019 deductions from business income?

**SOLUTIONS available in print and online Study Guide.**

## Half-Year Rules (a.k.a. First Year Rules)

### *Pre-November 21, 2018*

5-37. For many years, CCA calculations have been subject to what is referred to as either the half-year rules or, alternatively, the first year rules. Under these rules, which were presented in ITR 1100(2), the base to which the required CCA rate was applied was reduced by one-half of the net additions to the Class during the year. More specifically, in determining the end of period UCC for the calculation of maximum CCA, one-half of the excess, if any, of the additions to UCC for acquisitions, over the deductions from UCC for dispositions, was removed from the balance. As established by the use of the phrase "if any", this adjustment was only made when the net amount was positive. This served to reduce the amount of CCA that could be taken in the first year of an asset's life.

5-38. This old half-year rule applied to most asset classes. However, a few classes were exempt. Of the classes that we have described in Paragraph 5-36, there were two exemptions:

- All assets included in Class 14 (limited life intangible assets).
- Some Class 12 assets such as medical or dental instruments and tools costing less than $500, uniforms, and chinaware. Other Class 12 assets, such as computer software and certified Canadian films, were subject to the half-year rules.

### *Revised ITR 1100(2)*

5-39. This situation prevailed until the federal government presented its annual economic statement on November 21, 2018. This statement introduced a revised ITR 1100(2). This revised Regulation contains a fairly complex formula which, in simple terms, does two things:

- Instead of reducing the year of acquisition UCC balance on which CCA is calculated, increases this balance.
- Effectively retains the old half-year rule to be applied in certain specified situations.

5-40. The provisions of this revised Regulation are referred to as the Accelerated Investment Incentive (AccII). They are applicable to most depreciable asset acquisitions and their application will increase substantially the amount of CCA that can be taken on acquisitions for the first year. However, as we will see in our detailed discussion of the AccII, not all assets are eligible for the AccII. The assets that are not eligible for the AccII are subject to a half-year rule that operates in a manner identical to the old version of the half-year rule.

5-41. While it would be possible to illustrate the half-year rule at this point, it will be more useful to present an example in conjunction with our discussion of the AccII.

## Accelerated Investment Incentive (AccII)

### *Limitations On Our Coverage*

5-42. The AccII legislation contains a phased reduction in its benefits for taxation years after 2023. However, the initial provisions are in effect through that year. Given the length of time that these provisions are in effect, all of our examples and problems will focus on the period November 21, 2018 through December 31, 2023. We will not give any coverage of that changes that occur after that time.

5-43. The second point here is that our coverage will only deal with the AccII as it applies to the Classes that we have listed in Paragraph 5-36. There are additional provisions related to Canadian vessels and assets in Classes 43.1 and 43.2 (ex., clean energy assets). We will not provide any coverage of these provisions.

### *Basic Concepts*

5-44. Given the recent fairly dramatic reduction in corporate taxes in the U.S., the federal government felt a need to provide additional tax incentives to Canadian businesses. As Canadian taxes on corporations were already very favourable, cuts in this area did not seem feasible. Reflecting this, the federal government chose to use a different approach.

5-45. The approach chosen involves providing an incentive that should encourage businesses to make additional capital expenditures after November 20, 2018. As described in the previous section, prior to that date, businesses were only able to deduct CCA on one-half the cost of the net additions to depreciable assets in the year of acquisition. For most assets, the AccII removes this half-year rule and replaces it with a 50 percent increase in the base for calculating the amount of CCA that can be deducted.

**EXAMPLE** A business acquires a Class 8 asset with a capital cost of $100,000.

**ANALYSIS** The relevant calculations, both pre and post-AccII, would be as follows:

| | Pre-AccII | Post-AccII |
|---|---|---|
| Capital Cost | $100,000 | $100,000 |
| Adjustments: | | |
| Deduct: Half-Year Rule [(50%)($100,000)] | ( 50,000) | |
| Add: AccII Adjustment [(50%)($100,000)] | | 50,000 |
| CCA Base | $ 50,000 | $150,000 |
| CCA Rate | 20% | 20% |
| Year Of Acquisition CCA | $ 10,000 | $ 30,000 |

5-46. As this simple example illustrates, for most eligible assets, the AccII triples the amount of CCA that can be taken in the year of acquisition.

5-47. It is important to note, however, that the AccII does not increase the total amount of CCA that will be available on a given asset. The total will continue to be limited by the capital cost of the acquired asset. As we shall see in our more detailed examples, in the same manner that the half-year adjustment has been added back to assets, the AccII adjustment will be subtracted to arrive at the appropriate UCC balance for January 1 of the year following acquisition.

### *Eligible Assets - ITR 1104(4)*

5-48. To be eligible for the AccII, depreciable assets must be acquired and made available for use after November 20, 2018 and before 2028. In general, all Classes of depreciable assets can be eligible for the AccII. However, the manner in which the asset is acquired can cause it to be non-eligible for this incentive. Assets acquired in the following situations are not eligible.

**Assets Previously Owned By The Taxpayer**

**Assets Previously Owned By Non-Arm's Length Person**

**Assets Acquired On A Rollover Basis** While we do not cover rollovers until Chapters 16 and 17, the basic idea is property that is transferred from a non-arm's length person at an elected value, usually in order to defer taxes. An example of this would be the use of ITA 85 to transfer an unincorporated business to a corporation.

5-49. The basic idea behind these exceptions to eligibility is to prevent taxpayers from creating a "new" asset using a transaction that doesn't really involve a change in beneficial ownership. We will not encounter such situations until later Chapters. They will arise when there is a deemed disposition (Chapters 8 and 9) or a rollover (Chapters 16 and 17).

5-50. Other points that are relevant to this definition are as follows:

- To be eligible for the AccII, there is no requirement that the asset be new or unused. Used assets are eligible provided they were not acquired from a non-arm's length person or previously owned by the taxpayer.
- Eligibility requires that the asset be available for use. It is not sufficient to simply acquire an asset and not use it.

## Application - Declining Balance Classes

5-51. You will have noticed in reviewing the CCA Classes listed in Paragraph 5-36 that the majority of classes use declining balance calculations. This includes Classes 1, 3, 8, 10, 10.1, 14.1, 44, 50, and 53. The AccII follows the same basic procedure for eligible assets in all of these classes. We will give separate attention to the straight-line Classes 13 and 14. In addition, Classes 12 and 53 require somewhat different treatments.

5-52. The application of the AccII to the declining balance Classes involves an enhanced UCC basis for calculating CCA in the year of acquisition. Specifically, there will be an addition to the CCA base equal to 50 percent of the net of:

- the capital cost of eligible depreciable asset acquisitions during the year; less
- amounts deducted for disposal (the lesser of the capital cost and the proceeds of disposition) of depreciable assets, without regard to whether the assets disposed of are eligible or non-eligible. (This is accurate only if there are no AccII non-eligible acquisitions to the class during the year, which would be the normal business situation.)

5-53. In determining the beginning balance of UCC for the following taxation year, this addition will be reversed, thereby reducing the UCC by both the previous year's CCA and the AccII adjustment.

5-54. We will use a simple example to illustrate this procedure. We will also use this example to illustrate the application of the half-year rule that would apply if the acquired asset was not eligible for the AccII.

**EXAMPLE** Pohx Inc. has a taxation year that ends of December 31. On January 1, 2019 the UCC balance in Class 8 is $250,000. During 2019, the Company acquires additional Class 8 assets at a cost of $40,000. There are no additional Class 8 acquisitions in 2020, and there are no Class 8 disposals in either 2019 or 2020. Determine the 2019 and 2020 CCA and the January 1, 2020 and January 1, 2021 UCC under each of the following assumptions:

1. The acquired assets are not eligible for the AccII.
2. The acquired assets are eligible for the AccII.

**ANALYSIS** The required information can be calculated as follows:

| | Not Eligible For The AccII | Eligible For The AccII |
|---|---|---|
| January 1, 2019 UCC | $250,000 | $250,000 |
| 2019 Additions | 40,000 | 40,000 |
| Adjustments: | | |
| Deduct: Half-Year Rule [(50%)($40,000)] | ( 20,000) | |
| Add: AccII [(50%)($40,000)] | | 20,000 |
| CCA Base (December 31, 2019 UCC) | $270,000 | $310,000 |
| 2019 CCA At 20 Percent | ( 54,000) | ( 62,000) |
| Adjustment Reversals | 20,000 | ( 20,000) |
| January 1, 2020 UCC | $236,000 | $228,000 |
| 2020 CCA At 20 Percent | ( 47,200) | ( 45,600) |
| January 1, 2021 UCC | $188,800 | $182,400 |

Note that, while the 2019 CCA is larger on the eligible AccII acquisitions, it is smaller in 2020. This will be the case in all subsequent years, with the result that the total amount to be deducted will be the same for both eligible AccII assets and non-eligible AccII assets.

## Exercise Five - 3

**Subject:** CCA On Eligible AccII Assets

Radmore Ltd., with a taxation year that ends on December 31, has a Class 10 (30 percent) UCC balance on January 1, 2019 of $950,000. During 2019, it acquires 15 eligible AccII cars at a cost of $20,000 each, for a total addition of $300,000. The Company also disposes of 18 cars for total proceeds of $144,000. In no case did the proceeds of disposition exceed the capital cost of the vehicle being disposed of. Determine the maximum Class 10 CCA that Radmore can deduct for 2019, as well as the January 1, 2020 UCC balance.

**SOLUTION available in print and online Study Guide.**

### *AccII Application - Class 12*

5-55. As noted in Paragraph 5-36, Class 12 assets qualify for a 100 percent write off in the year of acquisition. Given this, the federal government decided that including this Class in the AccII program would not be necessary. With respect to medical and dental instruments, uniforms, chinaware, and tools costing less than $500, their cost could be completely written off in their year of acquisition. As a result, it would not have been possible to increase the acquisition year CCA deduction for these assets.

5-56. However, some items included in Class 12 were subject to the half-year rule, resulting in a CCA deduction on new acquisitions of only 50 percent. Specifically, computer software and certified Canadian films were subject to the half-year rule. Somewhat surprisingly, this was not changed by the AccII provisions. These Class 12 assets continue to be limited to a 50 percent write-off in the year of acquisition.

### *AccII Application - Class 13*

5-57. Class 13 is a straight-line class and was subject to the half-year rule. As with declining balance classes, the AccII removes the old half-year rule. However, instead of adding 50 percent to the base for calculating CCA, ITR 1100(1)(b)(i) allows the taxpayer to deduct 150 percent of the regular straight-line amount.

**EXAMPLE** In 2019, a business makes leasehold improvements of $50,000 that will be written off over the 5 year term of the lease.

**ANALYSIS** The 2019 CCA would be calculated as follows:

$$[(150\%)(\$50,000 \div 5)] = \$15,000$$

As this is a straight-line class, this increased CCA deduction in the first year would not alter the 2020, 2021, and 2022 CCA which revert to the regular straight-line amount of $10,000 ($50,000 ÷ 5). However, the $10,000 amount could not be deducted in 2023 as only $5,000 [$50,000 - $15,000 - (3)($10,000)] remains as a UCC balance. Because of this, the Regulation limits the CCA to the balance in the UCC. For the year 2023, the CCA would be $5,000.

This problem does not arise with declining balance classes as the increase of CCA in the year of acquisition is offset by reduced CCA in subsequent years, with no CCA being taken in the year of disposal.

5-58. While the calculation is different, the results in the year of acquisition are the same for Class 13 as they would be for the declining balance classes.

## Exercise Five - 4

**Subject:** Class 13 Additions

Vachon Ltd. has a December 31 year end. The Company leases its office space under a lease that was signed on January 1, 2014. The lease term is 10 years, with an option to renew at an increased rent for an additional 5 years. In 2014, the Company spent $52,000 renovating the premises. In 2019, changing needs require the Company to spend another $31,000 renovating the space. Determine the maximum amount of Class 13 CCA that the Company can deduct for 2019 and 2020.

**SOLUTION available in print and online Study Guide.**

### AccII Application - Class 14

5-59. While Class 14 is like Class 13 in that it is a straight-line class, it was not subject to the old half-year rules. In this case, there was no need to remove the half-year rule. For Class 14, the AccII adjustment is implemented in the same manner as is the case with the declining balance classes. ITR 1100(1)(c)(ii) provides a 50 percent addition to the base for calculating CCA.

## Exercise Five - 5

**Subject:** Class 14 Acquisitions

Arnot Ltd. has a December 31 year end. On April 1, 2019, Arnot pays $375,000 to enter a franchise agreement. The life of the franchise is 10 years. Determine the maximum CCA for 2019 and the January 1, 2020 UCC balance.

**SOLUTION available in print and online Study Guide.**

### AccII Application - Class 53 (100% Write-Off)

5-60. Class 53 is a 50 percent declining balance class that was subject to the old half-year rules. Reflecting the importance the federal government attaches to investment in manufacturing and processing, Class 53 benefits from a more generous AccII. Instead of adding 50 percent to the CCA base for calculating the acquisition year CCA, the AccII provisions add 100 percent of the capital cost of acquisitions.

**EXAMPLE** A taxpayer acquires a Class 53 asset with a capital cost of $200,000.

**ANALYSIS** The relevant calculations, both pre and post-AccII, would be as follows:

| | Pre-AccII | Post-AccII |
|---|---|---|
| Capital Cost | $200,000 | $200,000 |
| Adjustments: | | |
| Deduct: Half-Year Rule [(50%)($200,000)] | ( 100,000) | |
| Add: AccII [(100%)($200,000)] | | 200,000 |
| CCA Base | $100,000 | $400,000 |
| CCA At 50 Percent | ( 50,000) | ( 200,000) |
| Adjustment Reversals | 100,000 | ( 200,000) |
| UCC - Beginning Of Following Year | $150,000 | Nil |

As can be seen in this example, the AccII provides for a 100 percent write-off of Class 53 assets in the year of acquisition. In contrast to other declining balance classes, which tripled the year of acquisition CCA, the AccII quadruples the amount for Class 53 assets, resulting in a 100 percent write-off.

## Exercise Five - 6

**Subject:** Class 53 Acquisitions

On January 1, 2019, Arco Inc. has a balance in its Class 53 UCC of $500,000. During 2019, assets with a capital cost of $100,000 are added to the Class. There are no disposals during the year. Determine the maximum Class 53 CCA for 2019, as well as the January 1, 2020 UCC.

**SOLUTION available in print and online Study Guide.**

## Zero Emission Vehicles

### *Defined*

5-61. In a move designed to help reduce greenhouse emissions in Canada, the March 19, 2019 federal budget introduced provisions that would allow for enhanced CCA deductions on zero emission vehicles. To qualify for these provisions, a vehicle must:

- be a motor vehicle as defined in the *Income Tax Act*;
- a motor vehicle that would otherwise be included in Class 10, Class 10.1, or Class 16;
- be fully electric, a plug-in hybrid with a battery capacity of at least 15 kwh, or a motor vehicle fully powered by hydrogen; and
- not have been used for any purpose before it is acquired by the taxpayer.

5-62. The federal government has also implemented a $5,000 purchase incentive for zero emission vehicles. Vehicles that qualify for this incentive will not be eligible for the enhanced CCA deductions.

### *Implementation*

5-63. This program is implemented through the creation of two new CCA Classes. These are:

- Class 54 for those zero emission motor vehicles that were previously allocated to Classes 10 and 10.1.
- Class 55 for those zero emission motor vehicles that were previously allocated to Class 16.

5-64. In the case of Class 54, the amount of deductible CCA will be limited to $55,000, a figure that will be reviewed on an annual basis. Note that, for those vehicles that would have been allocated to Class 10.1, this is an improvement over the $30,000 deductible amount in that is available for assets in that Class.

5-65. For the period from March 19, 2019 through 2023, these two temporary Classes will be eligible for a 100 percent write off in the year of acquisition. The write off will be reduced to 75 percent for the years 2024 and 2025, and then to 55 percent for the years 2026 and 2027. It will not be available for 2028 and subsequent years.

5-66. While the default treatment will allocate zero emission vehicles to these new classes, taxpayers are allowed to elect out of this treatment and include the acquired vehicle in Class 10, Class 10.1, or Class 16. An example of where this might be desirable would be a Class 10 vehicle with a cost in excess of $55,000. While electing to have this vehicle included in Class 10 would restrict the first year CCA to 45 percent (AccII provisions enhance the normal 30 percent rate for this Class), the total amount of deductible CCA would be greater than $55,000.

### *Dispositions*

5-67. There is a special provision related to dispositions of Class 54 vehicles with a cost in excess of $55,000. However, in order to understand this provision, you need to be familiar with the general provisions for the disposal of depreciable assets. Given this, we will defer coverage of this special provision until the coverage of dispositions found later in this Chapter.

## Short Fiscal Periods

5-68. In the first or last years of operation of a business, or in certain other types of situations that will be covered in later chapters, a taxation year with less than 365 days may occur. Under these circumstances, the maximum CCA deduction for almost all of the classes listed in Paragraph 5-36 must be calculated using a proration based on the relationship between the days in the actual fiscal year and 365 days. Note that it is the length of the taxation year for the business, not the period of ownership of the asset, which determines the proration.

5-69. Somewhat surprisingly, the half-year rules were also applied in these situations, resulting in a double reduction in the maximum CCA amounts for assets acquired in a short fiscal period. Not surprising is the fact that the AccII provisions also apply in short fiscal periods to those assets that are eligible. For non-eligible assets, the half-year rules are applied in conjunction with the short fiscal period rules.

**EXAMPLE** Laing Ltd. begins operations on November 1, 2019 and has a December 31 year end. On November 11, it acquires Class 8 assets with a capital cost of $300,000. Determine the 2019 CCA under each of the following assumptions:

1. The acquired assets are not eligible for the AccII.
2. The acquired assets are eligible for the AccII.

**ANALYSIS** The required information can be calculated as follows:

| | Not Eligible For The AccII | Eligible For The AccII |
|---|---|---|
| Capital Cost | $300 000 | $300,000 |
| Adjustments: | | |
| Deduct: Half-Year Rule [(50%)($300,000)] | ( 150,000) | |
| Add: AccII [(50%)($300,000)] | | 150,000 |
| CCA Base | $150,000 | $450,000 |
| CCA Rate | 20% | 20% |
| CCA Pre Short Fiscal Period Adjustment | $ 30,000 | $ 90,000 |
| Short Fiscal Period Adjustment Factor | 61/365 | 61/365 |
| 2019 CCA | $ 5,014 | $ 15,041 |

5-70. Two additional points are relevant here:

- As noted previously, Class 14 assets are subject to pro rata CCA calculations, based on the number of days of ownership in the year. This eliminates the need for the application of the short fiscal period rules.
- When an individual uses assets to produce property income (e.g., rental income), the full calendar year is considered to be the taxation year of the individual. This means that the short fiscal period rules are not applicable in these situations.

## Exercise Five - 7

**Subject:** Short Fiscal Periods

Olander Inc. begins operations on August 1, 2019. On September 15, 2019, the Company acquires $115,000 in Class 8 assets. The Company has a December 31 year end and no other depreciable assets are acquired, or disposed of, before December 31, 2019. The assets are eligible for the AccII. Determine the maximum Class 8 CCA for the fiscal period ending December 31, 2019, as well as the January 1, 2020 UCC.

**SOLUTION available in print and online Study Guide.**

## Class 14.1 And The Repeal Of The CEC Regime

**BYRD/CHEN NOTE** While understanding of the CEC regime will be required by tax practitioners for many years to come, this is the last year that we will give any attention this subject. This reflects our desire to avoid having this text become a history book.

### *Additions To The Class*

5-71. Prior to 2017, goodwill and other intangible assets with unlimited lives (these assets were given the label "eligible capital expenditures") were added to a balance designated Cumulative Eligible Capital (CEC). Somewhat oddly, only three-quarters of the cost of these assets was added to this balance. Once added, the resulting balances were subject to write off at a 7 percent declining balance rate. In addition, the disposition of CEC items were subject to rules that varied significantly from those applicable to other asset dispositions.

5-72. It was widely recognized that there was no logical basis for the treatment given to CEC items and, as a consequence, for 2017 and subsequent years, the CEC provisions of the *Income Tax Act* were repealed. In somewhat simplified terms, the acquisitions that were once allocated to the CEC balance are now allocated to Class 14.1. More specifically, the items that will be allocated to Class 14.1 are as follows:

**Goodwill** We will give additional attention to this intangible asset in that its treatment under the Class 14.1 rules is somewhat different than its earlier treatment under the CEC regime.

**Intangible Assets Other Than Goodwill** This classification only includes intangible assets with unlimited lives. Those intangible assets with limited lives are allocated to Class 14 or, in the case of patents, Class 44. The following are examples of items that are added to Class 14.1:

- Customer lists purchased and not otherwise deductible.
- The cost of trademarks, patents, licences, and franchises with unlimited lives. (In general, if these expenditures have limited lives they are Class 14 or Class 44 assets.)
- Expenses of incorporation (now only amounts over $3,000 as explained in Paragraph 5-77), reorganization, or amalgamation.
- The costs of government rights.

- Appraisal costs associated with valuing intangible assets, such as a government right, and on an anticipated property purchase that does not take place.
- Initiation or admission fees to professional or other organizations for which the annual maintenance fees are deductible.
- Some payments made under non-competition agreements.

5-73. In addition to the items listed in the preceding paragraph, there will be a further one-time addition to Class 14.1 consisting of:

**December 31, 2016 CEC Balances** With the repeal of the CEC legislation, there was a need to deal with CEC balances that were present at the repeal date. As you would anticipate, this resulted in a number of fairly complex transitional provisions. These will be given attention at the end of this Chapter. At this point we would note that, in very simple terms, the CEC balance that was present on December 31, 2016 was added to the Class 14.1 balance as of January 1, 2017.

It is important to note that, in adding these balances to Class 14.1, they were not adjusted to 100 percent values. Rather they were transferred at the 75 percent values that were used under the CEC rules. This complicates CCA calculations and results in the need for some adjustment in the CCA rate, as well as adjustments related to dispositions. (See the transitional rules at the end of this Chapter.)

### Rates

5-74. The CCA rate for Class 14.1 is 5 percent, applied to a declining balance. This replaces the CEC rate of 7 percent, applied to a declining balance. However, this higher rate was applied to a smaller balance. When this is taken into consideration, the resulting reduction in the effective rate is very small:

| | |
|---|---|
| **Effective Rate - CEC** [(7%)(75%)] | 5.25 Percent |
| **Effective Rate - Class 14.1** [(5%)(100%)] | 5.00 Percent |

5-75. As noted in Paragraph 5-73, the CEC balances that were transferred to Class 14.1 were not adjusted to 100 percent values. As they were still based on 75 percent amounts, it would not be entirely appropriate to apply the Class 14.1 rate of 5 percent rate to these balances. This is reflected in the transitional rules which allow the old 7 percent rate to be applied to CEC balances that are carried forward from December 31, 2016. This higher rate can be applied for 10 years subsequent to 2016, at which point it is likely that most of these balances will have been reduced to insignificant amounts. The provisions for relief for small corporations that are discussed in the following paragraphs will assist with this.

### Relief For Small Corporations

5-76. For small corporations, additions to the CEC balance were usually very limited. There would always be an addition for the costs associated with incorporating. However, for many of these new corporations, this would be the only addition. While it was normally a small balance, under the application of declining balance amortization, it would remain on the books as long as the corporation existed.

5-77. To provide relief in this area, the change in legislation was accompanied by the addition of ITA 20(1)(b) which allows new corporations to deduct the first $3,000 of incorporation costs. While amounts in excess of $3,000 must be added to Class 14.1, in many cases, the $3,000 figure will cover all of the costs of incorporation and eliminate the need to establish a Class 14.1.

**EXAMPLE** Artone Inc. is incorporated on February 24, 2019. The costs associated with the incorporation are $2,700.

**ANALYSIS** In the absence of ITA 20(1)(b), the $2,700 would be added to Class 14.1 and amortized at the rate of 5 percent applied to a declining balance. In contrast, ITA 20(1)(b) allows this full amount to be deducted in 2019, with no amount added to Class 14.1.

5-78. A further problem for small corporations was the December 31, 2016 carry forward of unamortized CEC balances to Class 14.1. As the balance likely reflected incorporation costs, the amounts involved would usually be small. Further, under the declining balance CCA procedures they would have to be dealt with for a considerable period of time. To provide relief in this area, the Class 14.1 legislation allows for the deduction of a minimum CCA amount of $500 per year with respect to pre-2017 CEC balances carried forward.

**EXAMPLE** On December 31, 2016, Pharly Ltd. had a CEC balance of $750.

**ANALYSIS** The $750 CEC balance will become the January 1, 2017 UCC balance for Class 14.1. In the absence of a special provision, this balance would be subject to declining balance depreciation at a rate of 7 percent for the next ten years. However, with the ability to deduct a minimum CCA of $500 per year on this balance, it will be eliminated in two years, a $500 deduction in 2017, followed by a $250 deduction in 2018.

### Goodwill

5-79. The general concept of goodwill is that it reflects the excess of the total value of a business as a going concern that is in excess of the sum of the assets of a business that can be specifically identified. It reflects the fact that, if an organization puts a group of assets together in an effective manner, the resulting business can have a value that exceeds the current fair market value of the combined assets. As the source of this value cannot be identified, it is excluded from the concept of identifiable assets. Note that the concept of identifiable assets includes both tangible and intangible assets (e.g., while a patent is an intangible asset, its value can be "identified" as resulting from legal rights specific to that asset).

5-80. Under both accounting rules and the now repealed CEC legislation, goodwill was only recognized when a business was acquired at a cost in excess of the sum of its identifiable assets. Under the legislation related to Class 14.1, there are two components to goodwill:

- The conventional component based on the excess of cost of a business acquisition over the fair market values of its identifiable assets.
- Expenditures made by a business that do not relate to a specific property.

5-81. Unfortunately, the Department Of Finance has not provided guidance on the meaning of this latter concept. It would appear that it would include incorporation costs, as well as various types of reorganization costs. However, it is not clear what else might fall into this category.

5-82. This situation is further complicated by the Department's decision to allow the expensing of the first $3,000 of incorporation costs in the determination of net business income under ITA 20(1)(b). Only amounts in excess of $3,000, if any, are added to Class 14.1. Any amounts spent on amendments to the articles of incorporation are added to Class 14.1.

5-83. The other important feature here is that a business will only have one goodwill account. Even if there are multiple transactions resulting in goodwill, all such costs will be accumulated in a single capital cost for goodwill. While this is not important in terms of amounts added to Class 14.1 or the amount of CCA that will be taken on Class 14.1 balances, it will become important if there are disposals of goodwill. As will be discussed in the section titled "Dispositions Of Depreciable Assets", the fact that there is only one capital cost amount for the goodwill balance influences the results of such transactions.

5-84. A further point here requires some understanding of the legal forms through which business acquisitions can be implemented. While a specific business can have only one balance for its goodwill, ITR 1100(1) requires that when a taxpayer owns properties of the same CCA Class that are used in separate businesses, these assets must be segregated into separates CCA Classes. The consequences of this rule are as follows:

- If a business acquires goodwill as part of a business acquisition and continues to operate that business as a separate business, the acquired goodwill will be allocated to a separate Class 14.1 along with any other Class 14.1 assets for that separate business.

- If a business acquires goodwill as part of a business acquisition and absorbs that business into its other operations, the cost of the acquired goodwill will be added to the single goodwill balance of the acquiring business and included with any other amounts that are already in this balance.

5-85. This analysis is further complicated by the various legal forms that can be used for business organizations. Without going into detail, we would note that, if a corporation acquires another corporation and operates it as a subsidiary, any goodwill that was part of that transaction will not be recognized in the tax records of the parent company. While such goodwill would show up in the consolidated financial statements that the parent company would prepare under GAAP, Canadian tax legislation does not permit such consolidated statements. The parent and subsidiary would maintain separate tax records and file separate tax returns and the goodwill would not be present in the single entity tax records.

## Tax Planning Considerations For CCA

5-86. As previously noted, the rules for CCA are expressed in terms of maximum amounts that can be deducted. There is, however, no minimum amount that must be deducted, and this leaves considerable discretion as to the amount of CCA to be taken in a particular year. In fact, under certain circumstances, a taxpayer is allowed to revise the CCA for a previous taxation year. The guidelines for this type of amendment are found in IC 84-1. Note, however, that a revision of CCA for a previous year is only permitted if there is no change in the Tax Payable of any year.

5-87. If the taxpayer has Taxable Income and does not anticipate a significant change in tax rates in future years, tax planning for CCA is very straightforward. The optimum strategy will generally be to take the maximum CCA allowed to minimize Taxable Income and Tax Payable.

5-88. The situation becomes more complex in a loss year. If a taxpayer wishes to minimize a loss for tax purposes, one approach is to reduce the amount of CCA taken for the year (whether or not the taxpayer will wish to minimize a loss is affected by the loss carry over provisions that are discussed in Chapter 11). In these circumstances, it is necessary to decide on which class or classes the CCA reduction should be applied.

5-89. The general rule is that CCA should be reduced (i.e., not taken or taken in less than maximum amounts) on classes with the highest rates, while taking full CCA on those classes with the lowest rates. There could be exceptions to this general rule under certain circumstances such as if an asset is to be sold with recapture resulting, or if it is in Class 10.1 which does not allow recapture or terminal losses.

**EXAMPLE** A taxpayer has a $100,000 loss he would like to eliminate by reducing his CCA by $100,000. The UCC of Class 1 (4 percent) is $2,500,000 and the UCC of Class 10 (30 percent) is $333,333. Both classes would have maximum CCA of $100,000.

**ANALYSIS** If $100,000 in CCA is taken on Class 1, the following year's maximum CCA will be reduced by only $4,000, from $100,000 [(4%)($2,500,000)] to $96,000 [(4%)($2,400,000)].

In contrast, taking the $100,000 CCA on Class 10 would reduce the following year's maximum CCA by $30,000, from $100,000 [(30%)($333,333)] to $70,000 [(30%)($233,333)]. It would clearly be preferable to take the CCA on Class 1, so that the taxpayer has the option of taking higher CCA in the following year.

5-90. Similar opportunities arise when current tax rates are below those expected in the future. For example, some provinces institute periodic tax holidays for certain types of businesses. As taxes will be applied in future years, it may be advantageous to stop taking CCA in order to maximize Taxable Income during the years of tax exemption.

## Exercise Five - 8

**Subject**: CCA And Tax Planning

Monlin Ltd. has determined that, for the current year, it has Taxable Income before the deduction of CCA of $45,000. It is the policy of the Company to limit CCA deductions to an amount that would reduce Taxable Income to nil. At the end of the year, before the deduction of CCA, the following UCC balances are present:

| | |
|---|---|
| Class 1 (4%) | $426,000 |
| Class 8 (20%) | 126,000 |
| Class 10 (30%) | 89,000 |
| Class 10.1 (30%) | 21,000 |

There have been no additions to these classes during the year. Which class(es) should be charged for the $45,000 of CCA that will be required to reduce Taxable Income to nil? Explain your conclusion.

**SOLUTION available in print and online Study Guide.**

# Dispositions Of Depreciable Assets

## Overview Of Procedures

### *Basic Rule*

5-91. The basic rule for dealing with dispositions of capital assets is as follows:

**Basic Rule For Dispositions** When there is a disposition of a depreciable property, an amount will be deducted from the UCC balance in the relevant CCA Class. The deduction will be equal to the lesser of:

- The proceeds of disposition.
- The capital cost of the individual asset.

5-92. Note that, while we do not need the value of individual assets for purposes of determining maximum CCA, it is necessary to track the value of individual assets in order to apply this basic disposition rule. It is important to understand this in order to deal with the transition of CEC balances to the new Class 14.1. The reason for this, which will be discussed in more detail later in this section, is that under the old CEC regime, it was not necessary to know the capital cost of individual assets.

### *Dispositions With No Immediate Tax Consequences*

5-93. In the majority of cases, the proceeds of disposition for a depreciable asset will be less than its capital cost. In applying the basic rule, this means that the proceeds of disposition will be subtracted from the balance in the relevant CCA Class.

5-94. Given the broadly based nature of most CCA Classes, it is likely that a business would have additional assets in the Class subsequent to the disposition. Further, it is also likely that a balance will remain in the Class after the proceeds of disposition have been deducted. In such situations, there are no immediate tax consequences associated with the disposition. While the balance in the Class will be reduced and this will result in smaller CCA deductions in current and future years, the disposition does not give rise to any immediate income inclusion or deduction.

5-95. For students who are used to working with accounting procedures, this tends to be an uncomfortable result. The accounting procedures for dispositions require that we compare the proceeds of disposition for the individual asset with the net book value of that asset. It would be very unusual for these procedures not to result in either a gain (the proceeds exceed the net book value) or a loss (the proceeds are less than the net book value). In contrast, many, perhaps a majority, of depreciable asset dispositions have no immediate tax consequences.

**EXAMPLE** A business owns 20 vehicles, each with a cost of $25,000. All of these vehicles are in Class 10. On January 1, 2019, this Class has a UCC balance of $297,500. During 2019, one of these vehicles is sold for $15,000. The business has a December 31 year end. There are no further acquisitions or dispositions during the year ending December 31, 2019.

**ANALYSIS** The lesser of the vehicle's capital cost ($25,000) and the proceeds of disposition ($15,000) would be $15,000. This amount would be subtracted from the January 1, 2019 UCC, leaving a balance of $282,500 ($297,500 - $15,000). As there are additional assets in the class and the end of year balance is positive, the disposition would have no immediate tax consequences. Maximum Class 10 CCA for the year would be $84,750 [(30%)($282,500)], leaving a January 1, 2020 UCC of $197,750.

For accounting purposes, the gain or loss on this sale cannot be calculated without having the net book value of the vehicle sold. Unless the net book value was exactly $15,000, a somewhat unlikely value, there would be an accounting gain or loss on this sale.

### Dispositions With Tax Consequences

5-96. As noted in the previous section, the disposition of a depreciable asset will have no immediate tax consequences, provided that:

- The proceeds of disposition are less than the capital cost of the asset.
- There are additional assets in the CCA Class.
- There is a positive balance in the CCA Class at the end of the taxation year. Even if the balance is negative at the time of the disposition, there will still be no tax consequences, provided additions to the Class prior to the end of the year leave a positive balance.

5-97. While many dispositions meet these conditions, there will also be situations where one or more of these conditions are not present. When this happens, immediate tax consequences will arise. While we will discuss each of these results in more detail, in general terms the various possible consequences can be described as follows:

**Capital Gain** A capital gain will arise on the disposition of a depreciable asset if the proceeds of disposition exceed the capital cost of the asset.

**Recapture Of CCA** Subtraction of either the proceeds of disposition or the capital cost from the UCC may result in the creation of a ***negative balance in the class***. This can occur whether or not there are any assets left in the class. If this negative balance is not eliminated by new acquisitions prior to the end of the taxation year, this negative amount must be included in income as recapture of CCA. The amount will also be added to the UCC for the class, thereby setting the balance to nil for the beginning of the next year.

**Terminal Loss** This occurs only when there are ***no assets left in the class*** at the end of the year. If, when the proceeds from the disposition of the last asset(s) are deducted from the UCC for the class, a positive balance remains, this balance can be deducted as a terminal loss. Note that it is not a capital loss. A terminal loss is 100 percent deductible against any other income. The amount of the terminal loss will also be deducted from the UCC for the class, thereby leaving the balance at nil.

**No Capital Losses Possible** It is important to note that there is no possibility of a capital loss arising on the disposition of a depreciable asset. When a depreciable asset is acquired for use in a business, there is an expectation that it will decline in value as it is used to produce income. This is reflected in the fact that its tax value will be written down by taking fully deductible CCA. Given this, it would not be equitable to record a capital loss, only one-half of which would be deductible. The only type of loss that can arise on the disposition of a depreciable asset is a fully deductible terminal loss.

## Capital Gains

5-98. The tax rules related to capital gains are fairly complex and will be covered in detail in Chapter 8. However, in order to fully understand the tax procedures related to dispositions of depreciable assets, some understanding of this component of Net Income For Tax Purposes is required. The basic idea is that, if a depreciable capital asset is sold for more than its capital cost, the excess of the proceeds of disposition over the capital cost of the asset is a capital gain. As many of you are aware, only one-half of this gain will be included in the taxpayer's Net Income For Tax Purposes. As we have noted, this one-half of the capital gain is referred to as the taxable capital gain.

5-99. An important point to remember when calculating CCA is that this excess amount will not be deducted from the UCC. When the proceeds of disposition exceed the capital cost of the asset, the amount deducted from the UCC on the disposition is limited to its capital cost. This is reflected in the basic rule for dispositions that was presented in Paragraph 5-91.

### Exercise Five - 9

**Subject:** Capital Gains On Depreciable Assets

Vaughn Ltd. has a Class 8 balance of $275,000. During the current year, an asset with a capital cost of $18,000 is sold for $23,000. There are no other dispositions during the year and there are over 100 assets left in Class 8. What are the tax consequences of this disposition?

**SOLUTION available in print and online Study Guide.**

## Recapture Of Capital Cost Allowance

### *Procedures - Negative UCC Balance At Year End*

5-100. Recapture of capital cost allowance refers to situations in which a particular class contains a negative balance at the end of the taxation year. As previously described, the UCC ending balance for a particular class is calculated by starting with the opening balance of the class, adding the cost of acquisitions, and subtracting the lesser of the proceeds of disposition and the capital cost of any assets sold (CCA is subtracted at the beginning of the following taxation year). If the disposal subtraction exceeds the balance in the class, a negative balance will arise.

5-101. Note, however, that a disposition that creates a temporary negative balance at some point during the year does not create recapture. If additions to the class that are made later in the year eliminate this negative balance prior to year end, no recapture will have to be included in income.

5-102. It is important to note that acquiring additional assets of a particular class will not eliminate negative balances in those situations where each individual asset has to be allocated to a separate class (e.g., rental buildings costing $50,000 or more). As was intended by policy makers, when individual assets must be allocated to separate classes, a disposition that creates a negative balance at any time during the taxation year will result in recapture. This result cannot be eliminated as no subsequent acquisitions can be added to this separate class.

### *Economic Analysis*

5-103. Recapture of CCA arises when deductions from the class exceed additions and this generally means that the proceeds of the dispositions, when combined with the CCA taken, exceed the cost of the assets added to the class. In effect, recapture is an indication that CCA has been deducted in excess of the real economic burden of using the assets (cost minus proceeds of disposition). As a reflection of this situation, ITA 13(1) requires that the recaptured CCA be added back to income. The recapture amount is also added to the UCC balance, leaving a balance of nil at the beginning of the next taxation year.

## Exercise Five - 10

**Subject:** Recapture of CCA

At the beginning of 2019, Codlin Inc. has two assets in Class 8. The cost of each asset was $27,000 and the Class 8 UCC balance was $24,883. On June 30, 2019, one of the assets was sold for $28,500. There are no other additions or dispositions prior to the Company's December 31, 2019 year end.

What is the effect of the disposition on the Company's 2019 net business income? In addition, determine the January 1, 2020 UCC balance.

**SOLUTION available in print and online Study Guide.**

# Terminal Losses

### *Procedures - Positive Year End UCC Balance With No Remaining Assets*

5-104. When there is a disposition of the last asset in a CCA class, or the disposition of the only asset when a separate class is used, the resulting balance may be positive or negative. As discussed in the previous section, a negative balance will have to be included in income as recapture. If a positive balance remains, this balance is referred to as a terminal loss.

5-105. A terminal loss occurs only when there are no assets in the class at the end of the year. In contrast, recapture will occur whether or not there are assets in the class at the end of the year, as long as the balance is negative. (The belief that recapture will only occur if there are no assets in the class is a common misconception.) Similar to recapture, if there is a positive balance in the class at some point during the year, but no assets in the class, there is no terminal loss if additional assets are acquired prior to the end of the year.

5-106. Terminal losses are fully deductible in the determination of business or property income. In addition, the amount of the loss is subtracted from the CCA class, leaving a nil balance at the beginning of the following year.

5-107. An additional point here relates to employment income. While employees can deduct CCA on automobiles and aircraft and are subject to the usual rules with respect to recapture, the CRA has indicated that terminal losses cannot be deducted on such assets. The reason for this position is that ITA 8(2) indicates that employees can only deduct items that are listed in ITA 8. As terminal losses are not covered by this Section, no deduction is available. Note, however, that any recapture realized by an employee would be included in employment income.

### *Economic Analysis*

5-108. The presence of a positive balance subsequent to the sale of the last asset in the class is an indication that the taxpayer has deducted less than the full cost of using the assets in this class. Under these circumstances, ITA 20(16) allows this terminal loss to be deducted in full. As we have previously noted, this is not a capital loss. While it is possible to have capital gains on assets that are subject to CCA, it is not possible to have a capital loss on the disposition of a depreciable asset.

## Exercise Five - 11

**Subject:** Terminal Losses

At the beginning of 2019, Codlin Inc. has two assets in Class 8. The cost of each asset was $27,000 and the Class 8 UCC balance was $24,883. On June 30, 2019, both of these assets are sold for a total of $18,000. There are no other additions or dispositions prior to the Company's December 31, 2019 year end. What is the effect of the disposition on the Company's 2019 net business income? In addition, determine the January 1, 2020 UCC balance.

## Exercise Five - 12

**Subject**: Depreciable Asset Dispositions

Norky Ltd. disposes of a Class 8 asset for proceeds of $126,000. The capital cost of this asset was $97,000 and it had a net book value of $43,500. The Company's Class 8 contains a number of other assets and the balance for the Class prior to this disposition was $2,462,000. Describe briefly the accounting and tax treatments of this disposition.

**SOLUTIONS available in print and online Study Guide.**

## Dispositions Of Class 54 Assets (Zero Emission Vehicles)

5-109. In general, dispositions of Class 54 assets follow the usual rules with respect to dispositions of depreciable assets. If such assets sell for more than their capital cost, there will be a capital gain. If they sell for an amount that is equal to or less than their capital cost, the lesser of the capital cost and the proceeds of disposition will be subtracted from the UCC balance.

5-110. As the Class 54 UCC balance will always be zero because of the 100 percent write off in the year of acquisition, there will never be a terminal loss on these assets. However, dispositions will almost always result in recapture. This is not a problem when the asset has a capital cost that is less than $55,000. Such recapture will simply reflect amounts that have been deducted in the year of acquisition.

5-111. There is a problem, however with Class 54 assets with a capital cost in excess of $55,000. A simple example will serve to illustrate the issue:

**EXAMPLE** In December, 2019, Green Ltd. acquires a Class 54 vehicle at a cost of $150,000. Because of the limitation on Class 54 assets, the 2019 CCA on this vehicle is limited to $55,000 [(100%)($55,000)]. The January 1, 2020 UCC is nil and there are no other assets in Class 54.

The vehicle is sold in July, 2020 for $110,000. There are no Class 54 acquisitions during 2020.

**ANALYSIS** In the absence of a special provision covering this type of situation, the company would have to deduct the $110,000 from a nil UCC balance, resulting in recapture of $110,000. In effect, as a consequence of acquiring this vehicle, Green Ltd. experienced a $110,000 income inclusion after only being able to deduct $55,000. This is obviously not an equitable situation.

Fortunately, there is a relieving provision. ITA 13(7)(i)(ii) provides for using a deemed proceeds of disposition calculated as follows:

$$\left[\text{Actual Proceeds Of Disposition}\left(\frac{\text{Prescribed Amount } (\$55{,}000)}{\text{Capital Cost Of Asset}}\right)\right]$$

In our example, the resulting deemed proceeds of disposition would be calculated as follows:

$$\left[\$110{,}000\left(\frac{\$55{,}000}{\$150{,}000}\right)\right] = \$40{,}333$$

Using this deemed proceeds of disposition, recapture would be limited to $40,333 (Nil - $40,333), a much more favourable result than the $110,000 income inclusion that would arise if the normal disposition procedures were used.

## Dispositions Of Class 14.1 - Differences From Other Classes

### *Pre-2017 CEC Dispositions*

5-112. In order to understand the transitional rules that are presented at the end of this Chapter, you need to be aware of how, during the years prior to 2017, the treatment of eligible capital expenditure dispositions differed from other depreciable asset dispositions.

> **EXAMPLE (Pre-2017 CEC Regime)** On January 1, 2016, Fortco Inc. had a CEC balance of $260,000. During 2017, the Company disposes of an unlimited life franchise for proceeds of $130,000. The capital cost of this franchise was $30,000.
>
> **ANALYSIS** With this being a CEC situation, three-quarters of the proceeds of disposition would be subtracted from the CEC balance, without consideration of the capital cost of the franchise that is being sold. The CEC balance would be reduced to $162,500 [$260,000 - (3/4)($130,000)]. No capital gain would be recognized.
>
> In contrast, if this had been a regular CCA Class, the lesser of the proceeds of disposition of $130,000 and the capital cost of $30,000 would be subtracted from the UCC balance, leaving a UCC of $230,000 ($260,000 - $30,000). In addition, a taxable capital gain of $50,000 [(1/2)($130,000 - $30,000)] would be recognized.

5-113. Items that were previously added to CEC are now added to a regular CCA Class, Class 14.1. As this Class is subject to the general rule that a disposition requires the subtraction of the lesser of the capital cost of the individual asset and the proceeds of disposition from the Class, capital gains can arise on dispositions more frequently. We will return to this fact when we consider the economic impact of the replacement of the CEC regime with regular CCA procedures at the end of this Chapter.

### *Class 14.1 Anomalies*

5-114. The tax policy goal with respect to CEC expenditures was to eliminate the old CEC legislation which, in effect, provided a unique tax treatment for these expenditures, and to treat these items in a manner consistent with other depreciable assets. That is, CEC expenditures would be allocated to a CCA Class and be subjected to the same rules that applied to other depreciable assets as follows:

- 100 percent of the cost of eligible capital expenditures would be allocated to a Class;
- the balance would be written off using either straight-line or declining balance amortization; and
- when a disposition occurs, the lesser of the capital cost and the proceeds of disposition would be subtracted from the UCC of the Class.

5-115. While this desired change was largely implemented, two anomalies remain:

- ITA 13(34) deems that every business will have a single goodwill property. Unlike the situation with other assets added to Class 14.1, where a separate capital cost will be tracked for each asset, there will be only one capital cost for goodwill, regardless of the number of goodwill acquisitions that have been added to the Class.
- ITA 20(16.1) does not permit terminal losses on Class 14.1 assets as long as the business continues to operate.

5-116. We will give individual attention to each of these differences. You should note, however, that these differences do not alter the calculation of maximum CCA for the current year. They only become relevant when there is a disposition of Class 14.1 assets.

### Single Goodwill Account

5-117. As we have noted, each business will have only one goodwill property for each business. This means that we will not keep track of individual capital costs for each acquisition of goodwill. We are accustomed to the fact that a given CCA Class has only one UCC balance. However, as we pointed out in our general discussion of dispositions, each individual asset has a separate capital cost that is used to determine whether there is a capital gain on a disposition. This general rule applies equally well to additions to Class 14.1 other than goodwill. In contrast, even if we had a dozen additions to goodwill, there would be a single capital cost which sums these additions.

**EXAMPLE** During 2019, Brasco Ltd. acquires two businesses. The acquisition of Business 1 includes a payment for goodwill of $125,000, while the acquisition of Business 2 includes a payment for goodwill of $180,000. Neither of these businesses will be carried on as a separate business. This is important in that, if Brasco continued to operate these businesses separately, a separate Class 14.1 would be established for each business.

In December, 2020, a portion of Brasco's business is sold at a price that includes goodwill of $140,000. Brasco had no Class 14.1 balance as of January 1, 2019, and there were no other Class 14.1 transactions during 2019 or 2020.

**ANALYSIS** CCA on Class 14.1 for 2019 would be calculated as follows:

| | |
|---|---|
| January 1, 2019 Balance | Nil |
| 2019 Additions ($125,000 + $180,000) | $305,000 |
| AccII Adjustment [(50%)($305,000)] | 152,500 |
| CCA Base | $457,500 |
| 2019 CCA [(5%)($457,500)] | ( 22,875) |
| AccII Adjustment Reversal | ( 152,500) |
| January 1, 2020 UCC | $282,125 |

When a portion of Brasco's business is sold with a payment for goodwill of $140,000, we would subtract from the UCC balance the lesser of:

- the proceeds of disposition of $140,000; and
- the cost of the single goodwill property of $305,000.

There would be no immediate tax consequences resulting from the disposition and the new UCC figure for Class 14.1 would be $142,125 ($282,125 - $140,000).

5-118. You should note how this result would differ if Brasco had continued to operate either of the acquired businesses as a separate business. To illustrate this possibility, consider this modified version of the example from Paragraph 5-117.

**EXAMPLE** During 2019, Brasco Ltd. acquires two businesses. The acquisition of Business 1 includes a payment for goodwill of $125,000, while the acquisition of Business 2 includes a payment for goodwill of $180,000. Both of these businesses will be operated as separately managed businesses within the Brasco organization. Given this, there will be a separate Class 14.1 balance for each business.

In December, 2020, Business 1 is sold at a price that includes goodwill of $140,000. Brasco had no Class 14.1 balance as of January 1, 2019, and there were no other Class 14.1 transactions during 2019 or 2020.

**ANALYSIS** CCA on Class 14.1 for 2019 would be calculated as follows:

| | Business 1 | Business 2 |
|---|---|---|
| January 1, 2019 Balance | Nil | Nil |
| 2019 Additions | $125,000 | $180,000 |
| AccII Adjustments | | |
| [(50%)($125,000)] | 62,500 | |
| [(50%)($180,000)] | | 90,000 |
| CCA Base | $187,500 | $270,000 |
| 2019 CCA | | |
| [(5%)($187,500)] | ( 9,375) | |
| [(5%)($270,000)] | | ( 13,500) |
| AccII Adjustment Reversals | ( 62,500) | ( 90,000) |
| January 1, 2020 UCC (Total = $282,125) | $115,625 | $166,500 |

In 2020, the sale of the Business 1 would result in recapture as follows:

| | |
|---|---|
| January 1, 2020 UCC Of Business 1 - Class 14.1 | $115,625 |
| Disposition - Lesser Of: | |
| Proceeds Of Disposition = $140,000 | |
| Capital Cost = $125,000 | ( 125,000) |
| Negative Ending Balance = Recapture Of CCA | ($ 9,375) |

In addition, there would be a taxable capital gain of $7,500 [(1/2)($140,000 - $125,000)].

## Exercise Five - 13

**Subject**: Disposition Of Goodwill

During 2019, Dextrin Inc. acquires two businesses. The cost of the first acquisition includes a payment for goodwill of $85,000, while the cost of the second includes a payment for goodwill of $105,000. Neither of these businesses will be operated as a separate business entity. Dextrin Inc. had no Class 14.1 balance as of January 1, 2019, and there were no other Class 14.1 transactions during the year. In December 2020, two portions of Dextrin's business activities are sold. The first results in a goodwill receipt of $65,000, while the second results in a goodwill receipt of $105,000. Dextrin always claims maximum CCA. Determine the January 1, 2020 UCC balance. What is the tax effect of the dispositions?

**SOLUTION available in print and online Study Guide.**

### No Terminal Losses

5-119. As we have noted, a Class 14.1 disposition can only result in a terminal loss in those situations where the business as a whole is being terminated. A simple example will serve to illustrate this difference:

**EXAMPLE** On January 1, 2019, there is no balance in Roper Inc.'s Class 14.1. Later that month, the Company expands its business by acquiring an unlimited life franchise at a cost of $200,000. During February, 2020, the franchise is sold for $150,000. Roper Inc. continues its operations into 2021.

**ANALYSIS** The relevant calculations for 2019 and 2020 are as follows:

| | |
|---|---|
| Class 14.1 Balance - January 1, 2019 | Nil |
| 2019 Addition | $200,000 |
| AccII Adjustment [(50%)($200,000)] | 100,000 |
| CCA Base | $300,000 |
| 2019 CCA [(5%)($300,000)] | ( 15,000) |
| AccII Adjustment Reversal | ( 100,000) |
| January 1, 2020 UCC | $185,000 |
| Disposition - Lesser Of: | |
| Proceeds Of Disposition = $150,000 | |
| Capital Cost = $200,000 | ( 150,000) |
| December 31, 2020 UCC* | $ 35,000 |
| 2020 CCA [(5%)($35,000)] | ( 1,750) |
| January 1, 2021 UCC | $ 33,250 |

*Note that this $35,000 balance reflects the $50,000 ($200,000 - $150,000) loss on the disposition of the asset, reduced by the CCA of $15,000 already claimed in 2019.

5-120. If we were not dealing with a Class 14.1 asset, the $35,000 would have been deducted as a terminal loss, subtracted from the Class balance, and no CCA would have been taken. The only asset that was added to the Class was sold and a positive balance remains. In contrast, with Class 14.1, the $35,000 balance is left in the Class and the Company continues to deduct CCA in future periods.

5-121. There are a couple of possible reasons for this difference. First, it is consistent with the old CEC rules. Under this previous legislation, no deduction could be made for losses on CEC dispositions unless the business was being terminated. A second reason is more conceptual. We have noted that ITA 13(34) deems every business to have a goodwill property. That being the case, there will always be an asset left in the Class. That is, as long as a business is operating, there can be no situation in which no assets are left in Class 14.1. Given this, it would not be appropriate to deduct a terminal loss.

## Summary Of Disposition Tax Consequences

5-122. Figure 5-2 (following page) provides a summary of the various tax consequences that can result from dispositions of depreciable assets, along with a description of the conditions that lead to each possible consequence.

**Figure 5 - 2**
**Dispositions Of Depreciable Assets - Summary of Tax Consequences**

| Result | Conditions |
|---|---|
| Capital Gain | If the proceeds of disposition exceed the capital cost of the asset. A capital gain will normally be accompanied by recapture of CCA. |
| Recapture Of CCA | If a deduction resulting from a disposition exceeds the balance in the CCA Class and a **negative** balance remains at the **end** of the taxation year. An exception to this is Class 10.1 where recapture of CCA is not recognized. Note that recapture can occur even if there are still assets in the Class. |
| Terminal Loss | If the **last asset** in a CCA Class is disposed of and a **positive** balance remains in the Class at the **end** of the taxation year. The exceptions to this are Class 10.1 and Class 14.1 where terminal losses are not recognized. |
| No Immediate Tax Consequences | If all the following conditions are present:<br>• the proceeds of disposition are less than the capital cost of the asset (no capital gain),<br>• the disposition does not leave a negative balance in the CCA Class at the end of the taxation year (no recapture), and<br>• there are assets left in the CCA Class at the end of the taxation year (no terminal loss). |

# CCA Schedule

5-123. At this point, it is useful to summarize the CCA calculations in a schedule. A commonly used format is illustrated in the following example.

**EXAMPLE** The fiscal year end of Blue Sky Rentals Ltd. is December 31. On January 1, 2019, the UCC balance for Class 8 is $155,000. During the year ending December 31, 2019, $27,000 was spent to acquire Class 8 assets. During the same period, a used Class 8 asset was sold for $35,000. The capital cost of this asset was $22,000.

| | | |
|---|---|---|
| UCC Of The Class At The Beginning Of The Year | | $155,000 |
| Add: Acquisitions During The Year | $27,000 | |
| Deduct: Dispositions During The Year - Lesser Of: | | |
| • Capital Cost = $22,000 | | |
| • Proceeds Of Disposition = $35,000 | ( 22,000) | 5,000 |
| Add: AccII Adjustment [(50%)($5,000)]* | | 2,500 |
| CCA Base | | $162,500 |
| Deduct: CCA For The Year [(20%)($162,500)] | | ( 32,500) |
| Deduct: AccII Adjustment Reversal | | ( 2,500) |
| UCC Of The Class At The Beginning Of The Subsequent Year | | $127,500 |

*The AccII adjustment for 50 percent of the excess of eligible additions over both eligible and non-eligible disposal deductions is only made when the net amount is positive (e.g., the cost of acquisitions, if any, exceeds the amounts deducted for dispositions).

5-124. While this schedule is not designed to show this value, there is also a taxable capital gain of $6,500 [(1/2)($35,000 - $22,000)] resulting from the sale of the asset.

**We suggest you work Self Study Problems Five-1 through Five-7 at this point.**

# CCA Determination - Special Situations

## Separate Class Election

### *The Problem*

5-125. In our discussion of CCA procedures we noted that, in general, all assets of a particular type must be allocated to a single CCA class. However, we also noted that there were a number of exceptions to this general approach. For example, the *Income Tax Regulations* require that a separate class be used for each rental property with a cost in excess of $50,000.

5-126. As a further point, we noted that for certain other types of assets, the taxpayer could elect to use a separate CCA class for each individual asset. Now that you have an understanding of the procedures associated with dispositions of depreciable assets, we can meaningfully discuss the reasons for making such an election for certain types of assets.

5-127. Consider a $25,000 high volume photocopier that would normally be allocated to Class 8. After two years, the UCC balance would be calculated as follows:

| | |
|---|---|
| Capital Cost | $25,000 |
| CCA Year One Including AccII Adjustment | |
| [(20%)(150%)($25,000)] | ( 7,500) |
| CCA Year Two [(20%)($25,000 - $7,500)] | ( 3,500) |
| UCC - Beginning Of Year Three | $14,000 |

5-128. Given the rate of technological change in this area, it is possible that this photocopier would be replaced after two years. Further, the value of the old photocopier would likely be relatively small. If, for example, the photocopier was disposed of for proceeds of $5,000, there would be a terminal loss equal to $9,000 ($14,000 - $5,000).

5-129. There are two problems with this analysis:

- Most businesses will have more than one asset in Class 8. This disposition would leave other assets in the Class and no terminal loss could be recognized.
- Even if the photocopier is the only Class 8 asset, if the photocopier is replaced, the replacement would likely be acquired within the same taxation year, again resulting in a situation where no terminal loss could be recognized because there are remaining assets in the Class.

5-130. The election to allocate this photocopier to a separate Class 8 balance alleviates these problems. When the photocopier is disposed of, a terminal loss can be recognized, even if the business replaces it prior to year end or has other Class 8 assets.

### *Eligible Assets (Rapidly Depreciating Electronic Equipment)*

5-131. There are a number of high tech or electronic products that are normally included in Class 8 (20 percent declining balance) that have actual service lives that are significantly shorter than the rates applicable to that Class would imply. ITR 1101(5p) lists the following specific types of Class 8 assets that are eligible for separate class treatment, provided they have a capital cost of $1,000 or more:

- photocopiers (Class 8)
- electronic communications equipment, such as telephone equipment (Class 8)
- computer software (only if included in Class 8 rather than Class 12 or 50)

5-132. As noted in our earlier discussion, the purpose of this separate class election is to provide for the recognition of terminal losses on the disposition of certain short-lived assets. Under the usual single class procedures, such recognition is not usually possible, either

because there are assets remaining in the particular CCA class, or because the retired assets are being replaced on a regular and ongoing basis. Note that there are many types of rapidly depreciating electronic equipment currently available that are not listed, such as 3D printers.

## Exercise Five - 14

**Subject:** Separate Class Election

In January, 2019, Edverness Inc. acquires ten photocopiers at a cost of $20,000 each. In December, 2019, two of these photocopiers are traded in on faster machines with more features. The new photocopiers cost $22,000 each, and the Company receives a trade-in allowance for each old machine of $3,000. Indicate the amount(s) that would be deducted from 2019 business income if no election is made to put each photocopier in a separate class. Contrast this with the deduction(s) that would be available if the separate class election is used.

**SOLUTION available in print and online Study Guide.**

### *Non-Residential Buildings*

5-133. As noted in Paragraph 5-36, for Class 1 new non-residential buildings, there are enhanced CCA rates. The regular 4 percent rate is increased to 10 percent if more than 90 percent of the building is used for manufacturing and processing. If the building does not meet the manufacturing and processing test, but is used more than 90 percent for non-residential purposes in general, the rate is 6 percent.

5-134. The availability of these special rates is conditional on the taxpayer allocating each eligible building to a separate class. While this election allows for higher CCA rates, there is a possible downside to this alternative. With the higher rates, the building can be written off faster, resulting in a lower UCC. This means that, if the building is sold, there will likely be recapture of CCA. If the building had not been put in a separate class, this could be avoided by replacing the building before the end of the taxation year.

## Change In Use For Automobiles

5-135. In general, when there is a change in the use of a capital asset, the *Income Tax Act* requires that the change be treated as a deemed disposition/re-acquisition, a requirement that can result in tax consequences such as capital gains or recapture. To fully understand this requirement requires a fairly complete understanding of capital gains taxation. Given this, we have deferred our detailed coverage of this subject to Chapter 8.

5-136. However, in the problem material found in this Chapter and in the following Chapter 6 on Business Income, there are number of situations where an individual uses an automobile for both personal and business usage. In most of these situations, the amount of personal vs. business use will vary each year.

5-137. For example, assume that Sally Rand uses her automobile 20 percent for business in 2019 and 30 percent for business in 2020. Technically, such a change represents a change in use and, if no special provisions were available, Sally would have a deemed disposition/re-acquisition in 2020, resulting in a need to deal with the resulting tax consequences.

5-138. Fortunately, an alternative approach appears to be acceptable to the CRA. A CCA amount is calculated each year on the assumption that the car is used 100 percent for business or employment activities. Using this figure, the deductible amount is determined by multiplying the 100 percent use figure by the portion of the use that was business or employment related during the current year. This procedure avoids the complications associated with determining market values and recording annual deemed dispositions/re-acquisitions.

**EXAMPLE** Joan Stream acquires an automobile for $25,000. It will be used for both business and personal activities. During 2019, business milage is 40 percent of the total driven. In 2020, business usage increases to 60 percent of the total usage.

**ANALYSIS** Maximum CCA for 2019 would be $11,250 [(1.5)(30%)($25,000)]. This amount would be deducted from the UCC without regard to personal usage. The CCA deductible from 2019 business income for Joan would be $4,500 [(40%)($11,250)].

In calculating CCA for 2020, the 100 percent figure would be $4,125 [(30%)($25,000 - $11,250)] and the deductible amount would be $2,475 [(60%)($4,125)].

## Other Special Situations

5-139. There are a number of other situations which involve special rules that are applicable to real and deemed dispositions of depreciable assets. While all of the following special situations require an understanding of the concepts introduced in this Chapter 5, they also require a sound understanding of the taxation of capital gains and losses. Given this situation, we will defer our coverage of these situations to Chapter 8, Capital Gains And Losses.

5-140. Briefly described, these special situations are as follows:

**Changes In Use** While we have covered the special rules for changes in the use of an automobile, the basic rules for these transactions require a more complete understanding of capital gains. Given this, additional coverage will be required.

**Sale Of Real Properties (Land And Buildings)** When real properties are sold, it is not uncommon that the result is a capital gain on the land, combined with a terminal loss on the building. Given that the loss is fully deductible, while only one-half of the capital gain is subject to tax, it is not surprising that special rules are applicable.

**Replacement Properties** When an involuntary disposition (a disposition resulting from events such as fire or expropriation) occurs, it may result in large capital gains and recapture of CCA. Similarly, when there is a voluntary disposition (e.g., a business sells its assets to move to a new location), such taxable amounts may also arise. In such situations, the *Income Tax Act* has provisions that provide relief, provided the assets are replaced within a specified period of time. For example, these rules could mitigate the tax effect of the recapture arising in the situation described in Paragraph 5-134 where the taxpayer has elected to allocate a building to a separate class.

# CEC To Class 14.1 - Transitional Rules

**BYRD/CHEN NOTE** As was previously noted, the CEC regime ended on December 31, 2016. As was also noted, we will provide coverage of this material through this edition of our text which focuses on 2019. No further coverage of the CEC or the related transitional rules will be included in future editions of the text. In fact, we expect some users will choose to drop this material now. To facilitate this option, we have placed the material on the CEC transitional rules at the end of this chapter.

## Approach

5-141. When the Class 14.1 rules came into effect, existing CEC balances did not simply disappear. As a result, there was a need for rules to deal with the transition from the old CEC rules to the new Class 14.1 procedures. Given the magnitude of this change, it is not surprising to find that these rules are fairly complex. As an indication of this, the Department Of Finance explanatory notes related to these changes run to nearly 15 pages.

5-142. Providing detailed coverage of these rules in a general text such as this would clearly not be appropriate. This view is reinforced by the fact that, over time, the importance of these rules declines.

5-143. That being said, it would be equally inappropriate to provide no coverage of these transitional rules. Substantial CEC balances exist in the real world. Given this, we are providing coverage of those transitional rules that we view as necessary to understanding the changes. Specifically, we will deal with the following issues.

**Conversion Of CEC Balances To Class 14.1** CEC balances that existed on December 31, 2016 were converted to a January 1, 2017 Class 14.1 balance. If there have been numerous additions to and disposals from the CEC account, this can be somewhat complex. However, we will confine our presentation to situations where there have been a limited number of eligible capital expenditures and no disposals of CEC assets.

**Disposition Of Pre-2017 Asset** When there is a post-2016 disposal of a CEC asset acquired prior to January 1, 2017, the transitional rules require some adjustments to the normal disposal procedures for depreciable assets. We will provide coverage of these adjustments.

5-144. We would note that we will not provide coverage of the transitional rules related to:

- Taxation years that straddle the introduction of the Class 14.1 rules.
- Rules designed to prevent the use of non-arm's length transfers to take advantage of the transition from the CEC regime to the Class 14.1 rules.

## Basic CEC Procedures

5-145. In order to understand the transitional provisions related to this change, some understanding of the old CEC procedures is required. While we have made earlier references to parts of these procedures in various sections of the Chapter, a more complete presentation will facilitate your understanding of the transitional rules.

5-146. The basic CEC procedures can be described as follows:

**Additions** Only three-quarters of the cost of eligible capital expenditures was added to the CEC balance, unlike the normal CCA procedures for Class 14.1 (100 percent of additions). No half-year rule was applicable to CEC additions. The half-year rule is applicable to Class 14.1.

**Amortization** A rate of 7 percent was applied to the end-of-period CEC balance. The rate for Class 14.1 is 5 percent applied to the end-of-period balance

**Dispositions** Three-quarters of the proceeds of disposition were subtracted from the CEC balance. As we have noted, there was no comparison with the capital cost of the disposed asset. This is very different than the normal CCA procedures where the lesser of the proceeds of disposition and the capital cost of the asset is subtracted from the UCC balance. Also as noted, this difference will, in many situations, result in an income inclusion that would not have occurred under the old CEC procedures.

When the proceeds of disposition were subtracted from the CEC balance, there were two possible results:

- In most cases, a positive balance of CEC remained. In this case, there would have been no immediate tax consequences related to the disposal.
- If the result was a negative balance, the result was an income inclusion. Without becoming involved in the details applicable to this situation, we would note that the inclusion resembled recapture, or a taxable capital gain, or some combination of the two.

5-147. A simple example will serve to illustrate these procedures.

**EXAMPLE** A corporation begins operations on March 1, 2014 and acquires goodwill for $40,000 on May 24, 2014. In July, 2016, the goodwill is sold for $46,000. The company's fiscal year ends on December 31.

**ANALYSIS** The analysis of the cumulative eligible capital account would be as follows:

| | CEC Balance | CEC Deductions |
|---|---|---|
| Addition, May, 2014 [(3/4)($40,000)] | $30,000 | |
| CEC Amount [($30,000)(7%)(306/365)] | ( 1,761) | $1,761 |
| Balance, January 1, 2015 | $28,239 | |
| CEC Amount [($28,239)(7%)] | ( 1,977) | 1,977 |
| Balance, January 1, 2016 | $26,262 | |
| Proceeds Of Sale [(3/4)($46,000)] | ( 34,500) | |
| Balance After Sale | ($ 8,238) | $3,738 |

An amount of $3,738 that represents recapture of previous CEC deductions would be added to income in full.

The $4,500 excess ($8,238 - $3,738) would be multiplied by two-thirds to arrive at an income inclusion of $3,000. The logic behind this approach becomes clear when you recognize that $3,000 is one-half of the $6,000 ($46,000 - $40,000) gain on the sale of the goodwill, demonstrating that these procedures give capital gains treatment to gains on the disposition of CEC balances.

5-148. It is important to note that while the $3,000 represents one-half of the gain on the disposition of goodwill, a result that is like a taxable capital gain in terms of the amount, it is not a capital gain. It is of significance, as will be explained later in this section, that this $3,000 is business income. This is in contrast to the results that will occur with Class 14.1 dispositions where such amounts will be treated as taxable capital gains.

5-149. There were other special rules related to CEC, as well as an election to provide a different treatment of dispositions. However, coverage of these extra rules is not required to understand the transition to the new Class 14.1 procedures.

## Conversion Of CEC Balances

5-150. The basic conversion process does not involve any real complications. The transitional rules indicate that the CEC balance that is present on December 31, 2016 becomes the Class 14.1 UCC balance on January 1, 2017. While the basic rate for Class 14.1 is 5 percent, until 2027, an additional 2 percent of CCA is available on these carry forward amounts. In effect, the rate on these carry forward amounts is 7 percent (the old rate for CEC) for a period of 10 years.

5-151. As previously noted, in order to eliminate the need to deal with small amounts of these carry forward balances, the minimum CCA amount is $500 per year with respect to pre-2017 CEC balances carried forward.

**EXAMPLE** Cognor Ltd. has a December 31, 2016 CEC balance of $157,420.

**ANALYSIS** The $157,240 will become the January 1, 2017 balance of Class 14.1. If there are no other Class 14.1 transactions during 2017, maximum Class 14.1 CCA is equal to $11,019 [(7%)($157,420)]. Note that the half-year rule is not applicable to this addition to Class 14.1.

## Exercise Five - 15

**Subject**: Conversion Of CEC Balances

On December 31, 2016, Farmo Inc. has a CEC balance $149,610. There are no additions to or dispositions from Class 14.1 during 2017. During 2018, the only Class 14.1 transaction is the acquisition of an unlimited life franchise at a cost of $89,000. What is the maximum amount of Class 14.1 CCA that can be deducted for 2018?

**SOLUTION available in print and online Study Guide.**

5-152. While there are complications related to determining the capital costs of the former CEC assets, these only become relevant when there is a disposition. Given this, we will deal with these issues in the next section which covers post-2016 dispositions of pre-2017 CEC assets.

## Dispositions Of Pre-2017 CEC Assets

### *Determination Of Total Capital Cost*

5-153. With the application of the usual depreciable asset procedures to pre-2017 CEC assets, it will be necessary to determine the capital cost of the items that were included in this balance. This reflects the fact that, under the usual depreciable asset rules, a disposition is recorded by subtracting the lesser of the proceeds of disposition for the asset and its capital cost. This is in contrast to the CEC procedures under which proceeds of disposition were subtracted, without regard to whether this value was higher or lower than the capital cost of the asset.

5-154. We would remind you that, with respect to the goodwill component of Class 14.1, each business will have a single goodwill account, without regard to the number of items that have been added to or subtracted from this account. It follows that there will be only one capital cost for all of the goodwill items that are included in Class 14.1. This is in contrast to other Class 14.1 assets where individual capital costs will be determined for each addition to the account.

5-155. In somewhat simplified terms, the capital cost for the December 31, 2016 CEC balance, is calculated as follows:

[(4/3)(A + B)], where

**A** = The CEC balance at the beginning of the day on January 1, 2017.

**B** = The total amount of CEC deductions taken prior to January 1, 2017 that have not been recaptured.

5-156. A simple example will serve to illustrate this definition.

**EXAMPLE** The balance in Dupor Inc.'s CEC account on December 31, 2016 is $97,301. This is the amortized balance of an unlimited life franchise that was acquired in 2015 for $150,000. The amount added to the CEC balance was $112,500 [(3/4)($150,000)].

**ANALYSIS** The capital cost of the franchise would be calculated as follows:

| | |
|---|---:|
| [(4/3)($97,301)] | $129,735 |
| [(4/3)($112,500 - $97,301)] | 20,265 |
| Capital Cost - Unlimited Life Franchise | $150,000 |

## Exercise Five - 16

**Subject**: Determination Of Capital Cost

Falar Ltd.'s CEC balance on December 31, 2016 was $120,654. This is the amortized balance of two unlimited life franchises that were acquired in 2014. The first was acquired for $120,000. The second for $80,000. What is the total capital cost of the two unlimited life franchises on January 1, 2017?

**SOLUTION available in print and online Study Guide.**

### *Allocation Of Capital Cost To Individual Items*

5-157. If there have been no dispositions of CEC assets prior to December 31, 2016, this is a very simple process.

**EXAMPLE (No Pre-2017 CEC Disposition)** During 2016, Cybor Inc. acquires two unlimited life franchises, the first on January 1, 2016 for $100,000, the second on July 1, 2016 at a cost of $150,000. The Company deducts maximum amortization for 2016.

**ANALYSIS** The addition to the CEC balance for these acquisitions would be $187,500 [(3/4)($100,000 + $150,000)]. The deduction for amortization of these amounts would be $13,125 [(7%)($187,500)]. This would leave a CEC balance on December 31, 2016 of $174,375 ($187,500 - $13,215). This would then become the Class 14.1 UCC as of January 1, 2017.

The total capital cost for the Class 14.1 assets would be calculated as follows:

| | |
|---|---|
| [(4/3)($174,375)] | $232,500 |
| [(4/3)($13,125)] | 17,500 |
| January 1, 2017 Capital Cost | $250,000 |

As the total is simply the sum of the costs of the two CEC assets, $100,000 would be allocated to the first franchise and $150,000 would be allocated to the second franchise.

5-158. Unfortunately, the situation becomes more complex when there were CEC dispositions prior to December 31, 2016. This problem arises from the fact that, under the CEC rules, a disposition resulted in a deduction from the CEC balance equal to the proceeds of disposition, without regard to whether this was higher or lower than the capital cost of the asset being sold. To illustrate this problem, consider this modified version of the example from 5-130.

**EXAMPLE (With Pre-2017 CEC Disposition)** During 2016, Cybor Inc. acquires two unlimited life franchises, the first on January 1, 2016 for $100,000, the second on July 1, 2016 at a cost of $150,000. On November 1, 2016, the first franchise that was acquired is sold for $120,000. The Company deducts maximum amortization for 2016.

**ANALYSIS** The relevant calculations are as follows:

| | |
|---|---|
| Additions To CEC [(3/4)($100,000 + $150,000)] | $187,500 |
| Disposition [(3/4)($120,000)] | ( 90,000) |
| CEC Deduction Base | $ 97,500 |
| CEC Deduction [(7%)($97,500)] | ( 6,825) |
| December 31, 2016 CEC Balance | $ 90,675 |

The total capital cost for the Class 14.1 assets would be calculated as follows:

| | |
|---|---:|
| [(4/3)($90,675)] | $120,900 |
| [(4/3)($6,825)] | 9,100 |
| January 1, 2017 Capital Cost | $130,000 |

5-159. At this point, a transitional rule is required. In somewhat simplified terms, the rule indicates that the capital cost of individual assets is equal to the lesser of:

- the total capital cost; and
- the expenditure that was made to acquire the CEC asset.

5-160. In our example, the capital cost of the second franchise would be $130,000, the lesser of the $150,000 expenditure to acquire this asset and the CEC balance of $130,000.

5-161. The economics of this simple example are not difficult to understand. When the first franchise was sold, $90,000 was subtracted from the CEC balance. This was $15,000 more than the $75,000 that was put into the balance when the franchise was acquired. This results in a reduction in the amount of capital cost allocated to the other CEC asset of $20,000 [(4/3)($15,000)]. This is reflected in the fact that the capital cost allocated to the second franchise is $20,000 ($150,000 - $130,000) less than its cost.

## Exercise Five - 17

**Subject:** Allocation Of Capital Cost

During January, 2016, Corvex Ltd. acquired three unlimited life franchises. The first cost $126,000, the second $185,000, and the third, $94,000. To raise funds to pay their accountant's fees, the first and second of these franchises were sold during November, 2016. The first was sold for $142,000 and the second for $220,000. Corvex claims the maximum CEC deduction for 2016. Determine the total capital cost of the third franchise as of January 1, 2017.

**SOLUTION available in print and online Study Guide.**

### *CEC Dispositions After January 1, 2017 - Excess Recapture*

5-162. To this point we have covered only dispositions that occurred prior to January 1, 2017. In this context, we have provided examples of the calculation of both the initial UCC balance of the new Class 14.1, as well as the determination of the capital cost of the assets that are present when the new regime is initiated.

5-163. There is a problem, however, when one of the assets in the initial Class 14.1 balance is disposed of subsequent to January 1, 2017. A simple example will illustrate this problem:

**EXAMPLE** On July 1, 2016, Tabor Ltd. acquires an unlimited life franchise for $200,000. On July 1, 2017, this franchise is sold for $225,000. There was no balance in Tabor's CEC account on January 1, 2016 and no other CEC transactions during 2016.

**ANALYSIS** The relevant 2016 calculations are as follows:

| | |
|---|---:|
| January 1, 2016 CEC | Nil |
| 2016 Addition [(3/4)($200,000)] | $150,000 |
| CEC Deduction [(7%)($150,000)] | ( 10,500) |
| December 31, 2016 CEC | $139,500 |

5-164. The December 31, 2016 CEC balance will become the January 1, 2017 UCC for Class 14.1. The capital cost of the franchise will be:

| | |
|---|---|
| [(4/3)($139,500)] | $186,000 |
| [(4/3)($10,500)] | 14,000 |
| January 1, 2017 Capital Cost | $200,000 |

5-165. If we followed the usual rule for dispositions of depreciable property, we would subtract the lesser of the $200,000 capital cost and the $225,000 proceeds of disposition from the Class 14.1 balance of $139,500. The result would be recapture of $60,500 ($200,000 - $139,500). There would also be a taxable capital gain of $12,500 [(1/2)($225,000 - $200,000)].

5-166. The recapture figure is clearly unreasonable. The $60,500 figure is far in excess of the $10,500 CEC deduction that was actually taken. The source of this problem is the fact that we are deducting a 100 percent figure from a balance that only reflects 75 percent of the capital cost of the asset.

5-167. To deal with this problem, when there is a disposition, ITA 13(39) deems the taxpayer to have acquired an addition to Class 14.1 UCC equal to 25 percent of the lesser of the proceeds of disposition and the capital cost of the particular property. The calculation for the 2017 disposition, incorporating this rule, is as follows:

| | |
|---|---|
| January 1, 2017 UCC | $139,500 |
| Deemed Acquisition - Lesser Of: | |
| 25% Of Proceeds Of Disposition | |
| = [(25%)($225,000)] = $56,250 | |
| 25% Of Capital Cost = [(25%)($200,000)] = $50,000 | 50,000 |
| Adjusted Balance | $189,500 |
| Disposition - Lesser Of: | |
| Proceeds Of Disposition = $225,000 | |
| Capital Cost = $200,000 | ( 200,000) |
| Negative Ending UCC Balance = Recapture | ($ 10,500) |

5-168. As the $10,500 of recapture is equal to the CEC deduction actually taken, this is clearly a reasonable result.

### CEC Dispositions After January 1, 2017 - No Terminal Loss

5-169. The preceding example illustrates how the ITA 13(39) deeming rules solve the problem of excess recapture. However, it does not illustrate the application of this rule when the proceeds of disposition are less than the capital cost of the relevant asset. We will use a modified version of the Paragraph 5-163 example to illustrate this situation.

**EXAMPLE** On July 1, 2016, Tabor Ltd. acquires an unlimited life franchise for $200,000. On July 1, 2017, this franchise is sold for $160,000. There was no balance in Tabor's CEC account on January 1, 2016 and no other 2016 CEC transactions.

**ANALYSIS** Without going through the calculations again, the January 1, 2017 balance in the Class 14.1 UCC would be $139,500 and the capital cost of the asset would be $200,000. Using this information, the relevant calculation for the disposition would be as follows:

| | |
|---|---|
| January 1, 2017 UCC | $139,500 |
| Deemed Acquisition - Lesser Of: | |
| 25% Of Proceeds Of Disposition | |
| = [(25%)($160,000)] = $40,000 | |
| 25% Of Capital Cost = [(25%)($200,000)] = $50,000 | 40,000 |
| Adjusted Balance | $179,500 |
| Disposition - Lesser Of: | |
| Proceeds Of Disposition = $160,000 | |
| Capital Cost = $200,000 | ( 160,000) |
| December 31, 2017 UCC | $ 19,500 |
| CCA [(7%)($19,500)] | ( 1,365) |
| January 1, 2018 UCC | $ 18,135 |

5-170. Several points are relevant here:

- There was a $40,000 ($200,000 - $160,000) loss on the sale, three-quarters of which would be $30,000. In terms of the economics involved, the loss is reduced by the $10,500 CEC deduction in 2016 and results in the $19,500 ($30,000 - $10,500) UCC balance remaining subsequent to the disposition.
- Under normal CCA procedures, the $19,500 would be treated as a terminal loss. However, with respect to Class 14.1 dispositions, a terminal loss in Class 14.1 can only arise when the business ceases to operate.

**We suggest you work Self Study Problem Five-8 at this point.**

**Additional Supplementary Self Study Problems Are Available Online.**

## Economic Impact Of These Changes

5-171. The conversion of CEC balances to a regular CCA Class was a long overdue change. There was always something about the CEC procedures that was both odd and inconsistent with the treatment of other depreciable assets. However, while this change can easily be defended on conceptual grounds, it will have economic results that are largely unfavourable to most taxpayers.

5-172. To begin, in many cases, more income will have to be recognized. Under the old CEC regime, a disposition only resulted in income when it created a negative CEC balance. This was the case even when the proceeds of disposition were greater than the capital cost of the asset.

5-173. This is no longer the situation. As previously indicated, if a Class 14.1 asset is sold at a price in excess of its capital cost, a capital gain will be included in income. As is the case with other depreciable assets, there is no possibility of a capital loss on Class 14.1 dispositions.

5-174. A further problem involves the type of income that arises under the Class 14.1 rules. As shown in our basic example (see Paragraph 5-147), it was possible for a capital gains like figure to arise under the CEC procedures. While the amount of this inclusion was based on one-half of a gain, it was treated as business income, not as a capital gain. This is an important difference for Canadian controlled private companies in that capital gains are subject to combined tax rates as high as 54.7 percent (see Chapter 13). In contrast, the active business income of these companies could be taxed at a rate as low as 10 percent. While some of the higher taxes paid on capital gains can be refunded when the income is paid out of the corporation as dividends, the deferral of taxes that is available on active business income is lost.

**BYRD/CHEN NOTE** Do not be concerned if you don't fully understand the preceding paragraph. Such understanding requires a knowledge of corporate taxation which is not presented until Chapters 12 and 13.

5-175. As mentioned previously, another negative result from this change is a reduction in the write-off rate for these assets. The effective rate under the CEC regime was 5.25 percent [(7%)(75%)]. This was slightly higher than the Class 14.1 rate of 5 percent.

## Key Terms Used In This Chapter

5-176. The following is a list of the key terms used in this Chapter. These terms, and their meanings, are compiled in the Glossary located at the back of the Study Guide.

| | |
|---|---|
| Accelerated Investment Incentive (AccII) | Goodwill |
| Capital Cost | Half-Year Rules (a.k.a. First Year Rules) |
| Capital Cost Allowance (CCA) | Non-Depreciable Capital Property |
| Capital Gain | Recapture Of CCA |
| Class | Separate Class Rules |
| Cumulative Eligible Capital (CEC) | Short Fiscal Year |
| Declining Balance Method | Straight-Line Method |
| Depreciable Capital Property | Taxable Capital Gain |
| Disposition | Terminal Loss |
| Eligible Capital Expenditure | Undepreciated Capital Cost (UCC) |
| First Year Rules | Zero Emission Vehicles |

## References

5-177. For more detailed study of the material in this Chapter, we would refer you to the following:

| | |
|---|---|
| ITA 13(1) | Recaptured Depreciation |
| ITA 13(7.1) | Deemed Capital Cost Of Certain Property |
| ITA 13(26) to ITA 13(32) | Available For Use Rules |
| ITA 13(34) | Goodwill |
| ITA 13(35) | Outlays Not Relating To Property |
| ITA 13(36) | Receipts Not Relating To Property |
| ITA 13(37) to ITA 13(41) | Class 14.1 - Transitional Rules |
| ITA 14(1.01) | Election Re Capital Gain |
| ITA 20(1)(a) | Capital Cost Of Property |
| ITA 20(1)(b) | Incorporation Costs |
| ITA 20(16) | Terminal Loss |
| ITA 20(16.1) | Non-Application Of ITA 20(16) |
| ITR Part XI | Capital Cost Allowances |
| ITR II-VI | Capital Cost Allowances |
| IC-84-1 | Revision Of Capital Cost Allowance Claims And Other Permissive Deductions |
| S3-F4-C1 | General Discussion Of Capital Cost Allowance |
| S3-F9-C2 | Tax Incentives For Clean Energy Equipment |
| IT-79R3 | Capital Cost Allowance - Buildings Or Other Structures |
| IT-143R3 | Meaning Of Eligible Capital Expenditure |
| IT-195R4 | Rental Property - Capital Cost Allowance Restrictions |
| IT-206R | Separate Businesses |
| IT-472 | Capital Cost Allowance - Class 8 Property |

# Appendix - CCA Rates For Selected Assets

> Note that for your convenience, this Appendix of common CCA rates, as well as the 2019 rates, credits and other data, is available online as a .PDF file.

This Appendix lists the CCA Class and rate for assets commonly used in business. Restrictions and transitional rules may apply in certain situations. ITR Part XI contains detailed descriptions of the CCA Classes.

| Asset | Class | Rate |
|---|---|---|
| **Aircraft (including components)** | **9** | **25%** |
| Airplane runways | 17 | 8% |
| Automobiles, passenger | | |
| (See also **Zero Emission Vehicles**) | | |
| • Cost < or = Prescribed amount ($30,000 in 2019) | 10 | 30% |
| • Cost > Prescribed amount | 10.1 | 30% |
| Automotive equipment | 10 | 30% |
| **Bar code scanners** | **8** | **20%** |
| Billboards | 8 | 20% |
| Boats, canoes and other vessels | 7 | 15% |
| Bridges, canals, culverts and dams | 1 | 4% |
| Buildings Acquired Before 1988 | 3 | 5% |
| Buildings Acquired After 1987 - No Separate Class | 1 | 4% |
| Buildings (New Only) Acquired After March 18, 2007: | | |
| • Manufacturing and Processing In Separate Class 1 | 1 | 10% |
| • Non-Residential In Separate Class 1 | 1 | 6% |
| Buses | 10 | 30% |
| **Calculators** | **8** | **20%** |
| Cash registers | 8 | 20% |
| China, cutlery and tableware | 12 | 100% |
| Communications equipment | | |
| (including cellphones too dumb to be smartphones) | 8 | 20% |
| Computer hardware and systems software | | |
| (including smartphones and tablets) | 50 | 55% |
| Computer software (applications) | 12 | 100% |
| Copyrights | 14 | Straight-line |
| **Data network infrastructure equipment** | **46** | **30%** |
| Dies, jigs, patterns, and molds | 12 | 100% |
| Docks, breakwaters and trestles | 3 | 5% |
| **Electrical advertising billboards** | **8** | **20%** |
| Electronic point-of-sale equipment | 8 | 20% |
| Equipment (not specifically listed elsewhere) | 8 | 20% |
| **Fences** | **6** | **10%** |
| Films | 10 | 30% |
| Franchises (limited life) | 14 | Straight-line |
| Franchises (unlimited life) | 14.1 | 5% |
| Furniture and fixtures | | |
| (not specifically listed elsewhere) | 8 | 20% |
| **Goodwill** | **14.1** | **5%** |
| **Instruments, dental or medical (See Tools)** | | |
| **Kitchen utensils (See Tools)** | | |

| Asset | Class | Rate |
|---|---|---|
| **Land** | **N/A** | **N/A** |
| Landscaping | N/A | Deductible |
| Leasehold improvements | 13 | Straight-line |
| Licences (limited life) | 14 | Straight-line |
| Licences (unlimited life) | 14.1 | 5% |
| Linen | 12 | 100% |
| **Machinery and equipment** | | |
| (not specifically listed elsewhere) | **8** | **20%** |
| Manufacturing and processing equipment | | |
| • acquired before March 19, 2007 | 43 | 30% |
| • acquired after March 18, 2007 and before 2016 | 29 | 50% Straight-Line |
| • acquired after 2015 | 53 | 50% |
| **Office equipment** (not specifically listed elsewhere) | **8** | **20%** |
| Outdoor advertising billboards | 8 | 20% |
| **Parking area and similar surfaces** | **17** | **8%** |
| Patents (limited life) | 44 | 25% |
| Patents (unlimited life) | 14.1 | 5% |
| Photocopy machines | 8 | 20% |
| Portable buildings and equipment used in a construction business | 10 | 30% |
| **Radio communication equipment** | **8** | **20%** |
| Railway cars | 7 | 15% |
| Roads | 17 | 8% |
| **Sidewalks** | **17** | **8%** |
| Software (applications) | 12 | 100% |
| Software (systems) | 10 | 30% |
| Storage area | 17 | 8% |
| Storage tanks, oil or water | 6 | 10% |
| **Tangible Capital Assets** | | |
| (not specifically listed elsewhere) | **8** | **20%** |
| Taxicabs (See also **Zero Emission Vehicles**) | 16 | 40% |
| Telephone systems | 8 | 20% |
| Television commercials | 12 | 100% |
| Tools | | |
| • under $500 | 12 | 100% |
| • $500 or over | 8 | 20% |
| Trailers | 10 | 30% |
| Trucks and tractors for hauling freight | 16 | 40% |
| Trucks (automotive), tractors and vans | 10 | 30% |
| **Uniforms** | **12** | **100%** |
| **Video games (coin operated)** | **16** | **40%** |
| Video tapes | 10 | 30% |
| **Wagons** | **10** | **30%** |
| **Zero Emission Vehicles** | | |
| • previously allocated to Classes 10 and 10.1 (Maximum = $55,000 for 2019) | 54 | 100% |
| • previously allocated to Class 16 | 55 | 100% |

# Problems For Self Study (Online)

To provide practice in problem solving, there are Self Study and Supplementary Self Study problems available on MyLab Accounting.

Within the text we have provided an indication of when it would be appropriate to work each Self Study problem. The detailed solutions for Self Study problems can be found in the print and online Study Guide.

We provide the Supplementary Self Study problems for those who would like additional practice in problem solving. The detailed solutions for the Supplementary Self Study problems are available online, not in the Study Guide.

The .PDF file "Self Study Problems for Volume 1" on MyLab contains the following for Chapter 5:

- 8 Self Study problems,
- 2 Supplementary Self Study problems, and
- detailed solutions for the Supplementary Self Study problems.

# Assignment Problems

(The solutions for these problems are only available in the solutions manual that has been provided to your instructor.)

### *Assignment Problem Five - 1*

***(CCA And Tax Planning)***

For its taxation year ending December 31, 2019, Marion Enterprises has determined that its operating Net Income For Tax Purposes before any deduction for CCA amounts to $53,000. The Company does not have any Division C deductions, so whatever amount is determined as Net Income For Tax Purposes will also be the amount of Taxable Income for the taxation year.

On January 1, 2019, the Company has the following UCC balances:

| | |
|---|---|
| Class 1 (Building Acquired in 2004) | $876,000 |
| Class 8 | 220,000 |
| Class 10 | 95,000 |
| Class 10.1 (Porsche - Cost $110,000) | 25,500 |
| Class 10.1 (Cadillac - Cost $45,000) | 25,500 |

During 2019, the cost of additions to Class 10 amounted to $122,000, while the proceeds from dispositions in this class totaled $87,000. The capital cost of the assets retired totaled $118,000. None of the individual assets sold had proceeds of disposition that exceeded their individual capital cost. There were still assets in Class 10 on December 31, 2019.

There were no acquisitions or dispositions in Class 1, 8 or 10.1 during 2019. The Company plans to sell the Porsche in 2020 and expects to receive about $75,000.

During the preceding three taxation years, the Company reported Taxable Income totalling $39,000 for the three years.

**Required:**

A. Calculate the maximum CCA that could be taken by Marion Enterprises for the taxation year ending December 31, 2019. Your answer should include the maximum that can be deducted for each CCA class.

B. As Marion Enterprises' tax advisor, indicate how much CCA you would advise the Company to take for the 2019 taxation year, and the specific classes from which it should be deducted. Provide a brief explanation of the reasons for your recommendation. In determining your solution, ignore the possibility that 2019 losses can be carried forward to subsequent taxation years.

## Assignment Problem Five - 2

### (CCA Calculations)

The following information relates to Bodlink Manufacturing's depreciable assets.

1. During 2019, a new factory building was acquired at a cost of $1,656,000. The estimated value of the land included in the purchase price is $450,000. The building will be used 100 percent for manufacturing and processing activity. It will be allocated to a separate Class.
2. The January 1, 2019 balance in Class 3 was $936,000. During 2019, one of the buildings in this Class burned to the ground. It had a capital cost of $723,000. The insurance proceeds totaled $972,000.
3. The January 1, 2019 balance in Class 8 was $476,000. During 2019, the Company acquired Class 8 assets at a cost of $163,000. Class 8 assets with a capital cost of $105,000 were sold for proceeds of $86,000. None of the individual assets sold had proceeds that exceeded their individual capital cost.
4. The January 1, 2019 balance in Class 10 was $876,000. During 2019, 3 passenger vehicles were acquired at a cost of $26,000 each. In addition, a delivery van with a capital cost of $37,000 was sold for $16,000.
5. The January 1, 2019 balance in Class 10.1 was $25,500. The only asset in this Class was the CEO's $510,000 Rolls Royce. Because of public relations concerns with such an extravagant vehicle, the car was sold during 2019 for $385,000.
6. The January 1, 2019 balance in Class 13 was $149,500, reflecting improvements that were made in 2017, the year in which the lease commenced. These improvements were made on a property leased as office space for the Company's executives. The basic lease term is for 6 years, with an option to renew for a period of 2 years. Additional improvements, costing $75,000, were made during 2019.
7. The January 1, 2019 balance in Class 50 was $47,000. During 2019, there were additions to this Class with a capital cost of $23,500.
8. The January 1, 2019 balance in Class 53 was $645,000. During 2019, the Company acquired additional manufacturing and processing equipment at a cost of $232,000.

Bodlink Manufacturing always takes maximum CCA on each Class of depreciable assets.

**Required:** Calculate the maximum CCA that can be taken by Bodlink Manufacturing on each class of assets for the year ending December 31, 2019 and calculate the UCC for each class of assets on January 1, 2020. In addition, determine the amount of any capital gain, recapture, or terminal loss that arises. Ignore GST/HST/PST considerations and the replacement property rules that are covered in Chapter 8.

### Assignment Problem Five - 3

#### (CCA Calculations Over 5 Years)

Golden Dragon Ltd. begins operations in Vancouver on September 1, 2014. These operations include an elegant sit down restaurant specializing in northern Chinese cuisine, as well as a take out operation that provides home delivery throughout the city. To facilitate this latter operation, on October 12, 2014, the Company acquires 20 small cars to be used as delivery vehicles. The cost of these cars is $12,000 each and, for purposes of calculating CCA, they are classified as Class 10 assets.

During the first year of operations, the Company establishes a fiscal year ending on December 31. In the fiscal periods 2015 through 2019, the following transactions take place with respect to the Company's fleet of delivery cars:

**2015** The Company acquires five more cars at a cost of $12,500 each. In addition, three of the older cars are sold for total proceeds of $27,500.

**2016** There are no new acquisitions of cars during this year. However, four of the older cars are sold for total proceeds of $38,000.

**2017** In December, 2017, 13 of the original cars and 3 of the newer cars are sold for $128,000. It was the intent of the Company to replace these cars. However, because of a delay in delivery by the car dealer, the replacement did not occur until January, 2018.

**2018** In January of 2018, the Company takes delivery of 25 new delivery cars at a cost of $16,000 each. No cars are disposed of during 2018.

**2019** In March, 2019, there is a change in management at Golden Dragon Ltd. They conclude that the Company's take out operation is not in keeping with the more elegant image that the sit down restaurant is trying to maintain. As a consequence, the take out operation is closed, and the 27 remaining delivery cars are sold. Because of the large number of cars being sold, the total proceeds are only $268,000.

Golden Dragon Ltd. takes maximum CCA in each of the years under consideration.

**Required:** For each of the fiscal years 2014 through 2019, calculate CCA, recapture, or terminal loss for Golden Dragon's fleet of cars. In addition, indicate the January 1 UCC for each of the years 2015 through 2020.

### Assignment Problem Five - 4

#### (CCA Calculations)

The fiscal year of the Bostik Manufacturing Company, a Canadian controlled private company, ends on December 31. On January 1, 2019, the UCC balances for the various classes of assets owned by the Company are as follows:

| | |
|---|---:|
| Class 1 - Building (Note 1) | $342,000 |
| Class 8 - Office Furniture | 66,000 |
| Class 10 - Vehicles | 225,000 |
| Class 10.1 - President's Car | 25,500 |
| Class 13 - Leasehold Improvements | 26,125 |
| Class 14.1 | Nil |
| Class 50 - Computer Hardware | 48,000 |
| Class 53 - Manufacturing Equipment | 126,000 |

**Note 1** The Class 1 building was acquired new in 2017 for $400,000. It is used 100 percent for manufacturing and processing.

During the year ending December 31, 2019, the following acquisitions of assets were made:

| | |
|---|---|
| Class 8 - Office Furniture | $ 12,000 |
| Class 10 - Vehicles (Note 2) | 115,000 |
| Class 12 - Tools (Note 3) | 17,000 |
| Class 13 - Leasehold Improvements | 22,000 |
| Class 50 - Computer Hardware | 11,000 |

**Note 2** The acquired vehicle was a specialized delivery truck. A damaged delivery truck with an original cost of $53,000 was traded in on the purchase. The trade-in allowance was $15,000.

**Note 3** None of the tools that were acquired during the year cost more than $500.

During this same period, the following dispositions also occurred:

Class 8 - Old, well used and mismatched office furniture was donated to a local non-profit organization. The original cost of these assets totalled $35,000. The fair market value of these assets was negligible.

Class 10.1 - Once the President of Bostik saw how high the taxable benefit on his BMW 650 was, he ordered it sold. It had cost $120,000 in 2018. Because it had high mileage and was an unpopular colour, Bostik could only get $50,000 for it.

Class 53 - Since the manufacturing equipment was technologically old and the new equipment would be leased, all of the manufacturing equipment was sold for total proceeds of $27,000. Its original cost was $450,000.

**Other Information:**

1. The Company leases one floor of a building for $36,000 per year. It houses the headquarters of Bostik, including the office of the President. The lease was negotiated on January 1, 2016 and has an original term of 5 years. There are two renewal options on the lease. The term for each of these options is 3 years. The Company made $38,000 of leasehold improvements immediately after signing the lease. No further improvements were made until the current year.
2. On September 24, 2019, one of the Company's trucks fell into a sinkhole and disappeared. (The driver was making a delivery at the time and captured the slow fall on his cellphone.) At the time of the accident, the fair market value of the truck was $32,300. The proceeds from the Company's insurance policy amounted to $30,000. The original cost of the truck was $45,000.
3. In early 2019, one of Bostik's employees developed a unique manufacturing process that the company intends to market to other manufacturers. Bostik wanted to charge $50,000 for a licence with a 10 year life. However, they eventually accepted a payment of $100,000 for a licence that has an unlimited life. No internal costs were allocated to this process.
4. It is the policy of the Company to deduct maximum CCA in all years.

**Required:** Calculate the maximum 2019 CCA that can be taken on each class of assets, the January 1, 2020 UCC balance for each class, and any other 2019 income inclusions or deductions resulting from the information provided in the problem.

### Assignment Problem Five - 5

#### (CCA Calculations Over 3 Years)

Bob's Buttons is an unincorporated business that began operations on September 1, 2017. The owner/operator is Bob Pope and his business is selling decorative and promotional buttons to various clients throughout the city of Toronto and online. Clients include political parties, retail and online stores, sports teams, and various religious organizations.

When he began operations in 2017, he acquired the following assets:

- A building to house his operations. The total cost of the building was $862,000, including an estimated $220,000 for the land. The building is used exclusively for his business, with 92 percent of the space being used for manufacturing the buttons. The building is allocated to a separate Class 1.
- Furniture and fixtures with a cost of $120,000.
- Two customized delivery vehicles at a cost of $36,000 each.

Bob's business policy is to take maximum CCA. During 2018, the following transaction involving capital assets take place:

- As the business has enjoyed early success, on April 1, Bob purchases a $110,000 Lexus. He has large logos of the business painted on both sides of the vehicle. Since Bob inherited a Jeep, a Ferrari and a BMW motorcycle, he drives the Lexus 100 percent for business purposes.
- The business acquires four new delivery vehicles at a cost of $38,000 each. As part of this purchase, the two vehicles acquired in 2017 are traded in. An allowance of $21,000 is received for each vehicle.

As Bob believes in free speech and has been told repeatedly by his family that he has a very twisted sense of humour, some of his favourite buttons have created social media firestorms. After Bob receives death threats, he decides to terminate his business in 2019 and start a new home security business in Alberta. By December 31, 2019 all of the assets are sold. The proceeds are as follows:

**Building** The building is sold for $903,000, with $220,000 of this value allocated to the land on which the building is situated.

**Furniture And Fixtures** These assets are sold for $53,000.

**Delivery Vehicles** The four delivery vehicles are sold for $34,000 each.

**Lexus** The Lexus is sold for $62,000.

**Required:** Determine the maximum CCA that can be taken in each of the years 2017 through 2019. In your calculations, include and identify the UCC balances for January 1, 2018, January 1, 2019, and January 1, 2020.

In addition, indicate any tax effects resulting from the 2018 and 2019 dispositions. Ignore GST/HST considerations.

### Assignment Problem Five - 6

#### (Purchase And Sale Of Goodwill)

Mortex is a Canadian public company with a taxation year that ends on December 31. It is the policy of Mortex Ltd. to claim maximum CCA for all Classes. On January 1, 2019, Mortex had no balance in its Class 14.1.

The following five independent cases involve payments for goodwill and receipts for goodwill. In each case assume that Mortex has no other transactions during 2019 or 2020 that involve Class 14.1.

**Case One** During 2019, Mortex acquires two businesses. With the acquisition of Business 1, a payment of $86,000 is made for goodwill. With the acquisition of Business 2, a payment of $75,000 is made for goodwill. Both businesses are absorbed into Mortex's other operations.

During 2020, Mortex sells a portion of its business and, as a consequence, receives a payment for goodwill of $90,000.

**Case Two** Using the same information as in Case One, assume that Mortex continues to operate both of the 2019 acquisitions as separate businesses and that the $90,000 receipt for goodwill results from the sale of the first business acquired.

**Case Three** During 2019, Mortex acquires a business. The cost of this business includes a payment for goodwill of $96,000. The business is absorbed into Mortex's other operations and is not operated separately. Also during 2019, Mortex acquires an unlimited life franchise at a cost of $113,000.

During 2020, Mortex sells a portion of its business and, as a consequence, receives a payment for goodwill of $102,000.

**Case Four** Using the same information as in Case Three, assume that, instead of selling a portion of its business for an amount that includes goodwill of $102,000, the unlimited life franchise is sold for $102,000.

**Case Five** Using the same information as in Case Three, assume that, instead of selling a portion of its business for an amount that includes goodwill of $102,000, the unlimited life franchise is sold for $135,000.

**Required:** Determine the tax consequences for the years 2019 and 2020 in each of these five cases. Your answer should include the January 1, 2021 UCC balance for Class 14.1.

### *Assignment Problem Five - 7*

### *(CCA, Recapture, And Terminal Losses - Includes Taxable Capital Gain)*

On January 1, 2019, the beginning of its taxation year, Bard Ltd. has the following information on depreciable assets in its records:

| Type Of Asset | Undepreciated Capital Cost | Original Capital Cost |
|---|---:|---:|
| Class 8 Furniture | $ 24,000 | $147,000 |
| Class 1 Buildings (Acquired In 2005) | 562,000 | 846,000 |
| Class 10 Automobiles | 220,000 | 315,000 |

During the 2019 taxation year, the following transactions occur:

**Sale Of Furniture** Furniture with an original cost of $52,000 was sold for $36,000. There are still assets in Class 8 at the end of the year.

**Purchase And Sale Of Buildings** A new building was acquired on February 1, 2019 at a cost of $325,000. Of this total, $75,000 was the estimated value of the land on which the building was situated. The building will be used 100 percent for office space and is placed in a separate Class 1.

Also during the year, a building (including the land) with an original cost of $335,000 was sold for $352,000. Of the $352,000 received, $200,000 is for the land on which the building is situated. The adjusted cost base of the land was equal to the $200,000 proceeds of disposition.

**Sale Of Automobiles** An extensive analysis of capital and operating costs indicated that the Company would be better off leasing automobiles, rather than continuing to purchase and retain ownership of these assets. As a consequence, all of the Company's automobiles were sold on December 28, 2019 for $185,000. The leased vehicles were delivered on January 2, 2020.

**Required**: For the taxation year ending December 31, 2019 calculate the maximum CCA that can be deducted by Bard Ltd. for each CCA class. In addition, calculate the January 1, 2020 UCC balance for each class. As part of your answer, you should indicate any other tax consequences that would result from the described transactions.

### Assignment Problem Five - 8
### (CCA And CEC Transition Calculations)

Microhard Ltd. has a December 31 year end. As of January 1, 2019, Microhard had the following UCC balances for its various tangible assets:

| | |
|---|---|
| Class 1 | $606,929 |
| Class 8 | 347,291 |
| Class 10 | 142,800 |
| Class 13 | 175,500 |

Other information related to the Company's tangible assets is as follows:

**Class 1** The January 1, 2019 balance in Class 1 reflected a single building that was acquired in 2015 for $900,000. Of this total, $200,000 was allocated to the land on which the building was situated. On February 1, 2019, this building and the land was sold for $800,000. At this time, the value of the land was unchanged at $200,000.

A new building was purchased on November 15, 2019 at a cost of $950,000, with $150,000 of this total being allocated to the land on which the building was situated. The new building is used 50 percent for manufacturing and processing and 50 percent for office space. It is allocated to a separate Class 1.

**Class 8** On March 1, 2019, the Company acquired Class 8 assets for $111,256. As a result of trading in older Class 8 assets, the Company received a trade in allowance of $20,000, resulting in a net cost for the new assets of $91,256. The capital cost of the assets traded in was $58,425.

**Class 10** The January 1, 2019 balance in Class 10 reflects 8 vehicles that were being used by the Company's sales staff. Their original cost totaled $240,000. The Company decided it would be more economical to provide their sales staff with leased vehicles. To this end, the 8 vehicles were sold for proceeds of $150,000 on October 31, 2019. The amount received for each vehicle was less than its capital cost.

On August 1, 2019, the Company acquires a BMW 750 for the use of the Company's president. The cost of this vehicle was $142,000. The president drives it 65,000 kilometers during the 2019 fiscal year, with only 10,000 kilometers involving employment duties. The president is not a shareholder of Microhard.

**Class 13** Some of the Company's business is conducted out of a building that is leased. The lease, which had an initial term of 6 years, can be renewed for 2 additional years at the end of the initial term. Immediately after the lease was signed on January 1, 2017, Microhard spent $216,000 on leasehold improvements. During April, 2019, an additional $42,000 was spent upgrading this property.

On May 1, 2015, the Company purchased an unlimited life franchise for $124,000. This franchise was sold December 1, 2019 for $136,000.

It is the policy of the Company to deduct maximum CCA and the maximum write-off of cumulative eligible capital allowable in each year of operation.

**Required:** Calculate the maximum CCA for the year ending December 31, 2019. Your answer should include the maximum that can be deducted for each CCA class. In addition, indicate the amount of any recapture, terminal loss or taxable capital gain that results from dispositions during 2019.

# CHAPTER 6

# Income Or Loss From A Business

## Overview

### Net Income For Tax Purposes

#### *Where We Are At*

6-1. In Chapter 1, we indicated that much of this volume would be devoted to the concepts and procedures associated with determining Net Income For Tax Purposes. In terms of the *Income Tax Act*, this subject is covered in Part I, Division B. This Division, titled Computation Of Income, contains 11 Subdivisions, with the first three dealing with specific types of income. They are as follows:

**Subdivision a** Income Or Loss From An Office Or Employment

**Subdivision b** Income Or Loss From A Business Or Property

**Subdivision c** Taxable Capital Gains And Allowable Capital Losses

6-2. At this point, we have provided fairly comprehensive coverage of the first of these Subdivisions. In Chapter 3, we discussed in detail the inclusions and deductions that go into the calculation of employment income or loss.

6-3. While we could have followed the discussion of employment income with coverage of the other components of Net Income For Tax Purposes, we chose to devote Chapter 4 to an introduction to Taxable Income and Tax Payable for individuals. While most texts leave this subject until the end of their coverage of all components of Net Income For Tax Purposes, we provided this introduction so that we could include comprehensive problems at an early stage in the text.

6-4. Again in contrast to some other texts, we introduced CCA calculations in Chapter 5, prior to our coverage of business income. As you are now aware, this is a very technical subject which involves what is often one of the most important deductions in the determination of business and property income. It was included prior to our coverage of business income in order to facilitate the presentation of complete examples of the determination of business income.

#### *Where We Are Going*

6-5. Chapters 6, 7, and 8 will provide coverage of the remaining specific types of income that go into the determination of Net Income For Tax Purposes. While business income and property income are dealt with in a single Subdivision of the *Income Tax Act*, these two types of

income are subject to somewhat different rules. In addition, in some circumstances, they are subject to significantly different rates of tax. Given this, we will deal with Subdivision b in two separate Chapters. This Chapter 6 will cover business income, with Chapter 7 dealing with property income.

6-6. The final major component of Net Income For Tax Purposes, taxable capital gains and allowable capital losses, will be dealt with in Chapter 8.

## Classification Of Income

### *A Net Determination*

6-7. We have then, four basic types of income:

- employment income;
- business income;
- property income; and
- capital gains.

6-8. Each of these basic types is determined on a net basis. That is, each amount that is to be included in Net Income For Tax Purposes is based on a specific group of inclusions that will usually be reduced by a specific group of deductions.

6-9. In general, the deductions applicable to one type of income cannot be deducted against the inclusions in a different type. However, if a loss is created in a particular year by an excess of deductions over inclusions, that loss can generally be applied against other types of income. The exception to this is a current year net capital loss. While such losses can be carried back or forward to other taxation years, they cannot be applied against other types of income that have been recognized during the current year. In fact, even in carry over years, allowable capital losses can only be deducted to the extent that taxable capital gains are present.

### *Applicable Taxpayers*

6-10. Employment income is unique in that only individuals can earn this type of income. In contrast, business income, property income, and capital gains can be recognized by all taxpayers. This would include individuals, corporations, and trusts.

### *Classification And The Use Of Property*

6-11. Business income, property income, and capital gains generally involve the use of property. Further, it is usually the manner in which the property is being used that determines the classification of the resulting income. Because of this, it is important to understand the use of this term in the *Income Tax Act*.

6-12. Property is defined very broadly in ITA 248(1) as "property of any kind whatever whether real or personal or corporeal or incorporeal". This would include both depreciable and non-depreciable property. The definition also encompasses both tangible and intangible property.

6-13. In terms of classifying the various types of income, it is useful to identify four categories of property on the basis of the manner in which they are used.

> **Property Acquired For Use In A Business** These are assets acquired to be used in a business. Examples would be factory and store buildings, the land underlying such buildings, furniture and fixtures in a retail store, and equipment used in manufacturing. While these assets are held, the income produced will be classified as business income. If the taxpayer disposes of such assets, classification of the income that is produced will depend on the type of asset.
>
> > **Non-Depreciable Capital Assets** A disposition will result in a capital gain or a capital loss.

**Depreciable Capital Assets** A disposition may result in recapture, a capital gain and recapture, a terminal loss, or no immediate tax consequences (we would remind you that capital losses cannot arise on the disposition of depreciable assets). As noted in Chapter 5, both recapture and terminal losses are components of business income when the asset is used in the business.

**Property Acquired And Held As An Investment** These assets are acquired to be held while they produce income. They are distinguished from business assets in that they produce income with little or no effort on the part of the acquirer. Examples would be holdings of debt securities, holdings of equity securities, and ownership of rental properties. While they are held, these investment assets produce property income. As was the case with assets acquired for use in a business, the classification of income that results from a disposition of such assets will depend on whether the asset is depreciable or non-depreciable.

**Non-Depreciable Capital Assets** A disposition will result in a capital gain or a capital loss.

**Depreciable Capital Assets** A disposition may result in recapture, a capital gain and recapture, a terminal loss, or no immediate tax consequences. Both recapture and terminal losses are components of property income when the asset is used to produce property income.

**Property Acquired For Resale At A Profit** These assets are acquired with the objective of reselling them at a profit. Examples would be the typical inventory balances that are held by many businesses. Any gain or loss that arises on their disposition will be treated as a business income or loss, not as a capital gain or loss. In most cases, such assets will not produce income while they are held.

**Property Acquired By Individuals For Personal Use** These are assets acquired by individuals for personal use. Examples would be personal use automobiles, personal use boats, and real property that is not held to produce income. While these assets are held they do not produce income. However, if they are sold at a value in excess of their adjusted cost base, the excess will be subject to tax as a capital gain. Alternatively, if they are sold for less than their adjusted cost base, the resulting loss will generally not be deductible (see the discussion of personal use property in Chapter 8).

6-14. As you can see, this categorization of the various ways a property can be used serves to outline how the various types of income are classified. The types of income produced by the various categories of property are summarized in Figure 6-1.

**Figure 6-1 - Classification Of Income**

| Use Of Property | Income While Held | Income At Disposition |
|---|---|---|
| **Used In Business** | | |
| Depreciable | Business Income | Capital Gain, Recapture, Terminal Loss, Or No Income |
| Non-Depreciable | Business Income | Capital Gain (Loss) |
| **Acquired As Investment** | | |
| Depreciable | Property Income | Capital Gain, Recapture, Terminal Loss, Or No Income |
| Non-Depreciable | Property Income | Capital Gain (Loss) |
| **Acquired For Resale** | Generally None | Business Income (Loss) |
| **Acquired For Personal Use** | None | Capital Gain (In general, losses are not deductible) |

### Areas Of Controversy

6-15. In many situations, classification presents no problems.

- An individual being paid an hourly rate on the General Motors assembly line is clearly earning employment income.
- An individual operating a Second Cup franchise is clearly earning business income.
- An investor receiving interest on a guaranteed investment certificate is clearly earning property income.

6-16. However, this is not always the case. As the manner in which income is classified can have significant tax consequences, it is not surprising that classification is a controversial issue in some situations. In general terms, there are three types of problems that can arise:

**Business Income Vs. Employment Income** For some individuals, it is not clear whether they are working as an employee or, alternatively, as an independent contractor earning business income (a.k.a., self-employed individual). The tax consequences and classification guidelines related to this issue were discussed, in detail, in Chapter 3.

**Business Income Vs. Property Income** While income producing assets are being held, there may be a question as to whether they are producing business income or, alternatively, property income. The tax consequences and classification guidelines related to this issue will be discussed in this Chapter.

**Business Income Vs. Capital Gains** On dispositions of property, it is sometimes difficult to establish whether the resulting gain is business income or, alternatively, a capital gain. The tax consequences and classification guidelines related to this issue will also be discussed in this Chapter.

# Business Income Vs. Property Income

## Tax Consequences Of Classification

### Rates

6-17. For individuals, both business income and property income will generally be subject to tax at the rates that were discussed in Chapter 4. This will require the application of a progressive rate structure, beginning at the low federal rate of 15 percent and increasing to the maximum federal rate of 33 percent. In terms of applicable rates, the business vs. property classification is not a significant issue for individuals.

6-18. This is not the case for corporations. If a corporation is Canadian controlled and its shares are not publicly traded, the first $500,000 (federal amount) of its business income may be eligible for a small business deduction that, in effect, can lower the corporate tax rate by up to 15 percentage points. Property income earned by such corporations is not eligible for this deduction and, as a result, will be much more heavily taxed. This makes the business vs. property classification a very important consideration for Canadian controlled private corporations.

### Other Considerations

6-19. Other tax considerations related to the business vs. property income classification are as follows:

- **CCA Calculations** When property income is being earned, the deduction of capital cost allowance (CCA) generally cannot be used to create or increase a net loss for the period. In addition, when property income is being earned by individuals, there is no requirement for a pro rata CCA reduction to reflect a short fiscal period. If business income is being earned, CCA can be used to create a loss. However, CCA deductions must generally be prorated for short fiscal periods.

- **Attribution Rules** When property income is being earned, the income attribution rules (see Chapter 9) are applicable. This is not the case when business income is being earned.
- **Earned Income Calculations** Property income is generally not included in the determination of earned income, either with respect to RRSP contributions or the limit on child care cost deductions. Business income is included in these figures.
- **Expense Deductions** Certain expenses can be deducted against business income, but not property income. These include write-offs of goodwill and most travel expenses. In contrast, for individuals, there is a deduction for foreign taxes on property income in excess of 15 percent that is not available against foreign business income.

## Business Income Defined

### General Rules

6-20. ITA 9 indicates a taxpayer's business income is his profit from a business. While profit is not defined in the *Act*, it is generally understood that it is a net amount resulting from the application of generally accepted accounting principles, modified by the rules found in Subdivision B. Business is defined in the *Act* as follows:

> **ITA 248(1)** Business includes a profession, calling, trade, manufacture or undertaking of any kind whatever and, except for the purposes of paragraph ..., an adventure or concern in the nature of trade ...

6-21. While this definition lists some of the things that might be considered to be a business, it does not provide a description of the characteristics that identify these activities as a business. A more useful definition can be found in Abstract No. 124 from the CICA's Emerging Issues Committee (now withdrawn):

> A business is a self-sustaining integrated set of activities and assets conducted and managed for the purpose of providing a return to investors. A business consists of (a) inputs, (b) processes applied to those inputs, and (c) resulting outputs that are used to generate revenues.

6-22. Some of the other principles involved in making the distinction between business and property income are as follows:

- Whether income is from a business or property is a question of fact. The fact that property is used to earn income is not determinative.
- Where funds are employed and risked by a business and the investment of these funds is necessary for the taxpayer to conduct its business, the income from this investment activity will likely be considered income from a business.
- Income from property does not require active and extensive business-like intervention to produce it; it is passive income resulting from the mere ownership of property, without a significant commitment of time, labour, or attention.
- Income from business requires organization, systematic effort, and a certain degree of activity.

### Adventure Or Concern In The Nature Of Trade

6-23. When a person habitually does a thing that is capable of producing a profit, then he is carrying on a trade or business, notwithstanding that these activities may be quite separate and apart from his or ordinary occupation. An example of this would be a dentist who habitually buys and sells real estate.

6-24. Where such a thing is done only infrequently, or possibly only once, it still is possible to hold that the person has engaged in a business transaction if it can be shown that he has engaged in "an adventure or concern in the nature of trade". If this is the case, the ITA 248(1) definition of a business makes it clear that any income that is produced will be considered

business income. In addition, any gain or loss arising on the disposition of any property acquired as part of this adventure or concern will be considered business income, rather than a capital gain or loss.

6-25. As described in IT-459, "Adventure Or Concern In The Nature Of Trade", factors that would identify a transaction as an adventure or concern in the nature of trade are as follows:

**Taxpayer's Conduct** If the taxpayer's actions in regard to the property in question were essentially what would be expected of a dealer in such a property, it would be considered to be an adventure or concern in the nature of trade.

**Nature Of The Asset** If the asset in question was not capable of producing income, this would indicate an adventure or concern in the nature of trade.

**Taxpayer's Intention** If the taxpayer acquired the asset with an intention to sell, this would be evidence of an adventure or concern in the nature of trade.

## Property Income Defined

6-26. While the *Income Tax Act* does not define income from property, it can be thought of as the return on invested capital in situations where little or no effort is required by the investor to produce the return. Falling into this category would be rents, interest, dividends, and royalties earned for the right to use property. In terms of tax legislation, capital gains are not treated as a component of property income, even in cases where they arise on investments being held to produce property income (e.g., capital gains on dividend paying shares).

6-27. In cases where a great deal of time and effort is directed at producing interest or rents, such returns can be considered business income. For example, while rent is generally viewed as a type of property income, the rents earned by a large real estate holding company would be treated as a component of business income.

### Exercise Six - 1

**Subject:** Business Vs. Property Income

Joan Bullato, because of her great fondness for his music, has purchased the rights to one of the songs written by John Clapton. She estimates that the royalties from the song will total about $35,000 per year for the next few years. She has no plans to buy any additional song rights. Explain whether the royalties she receives would be treated as business income or property income. In addition, indicate how any gain or loss on a disposition of the rights would be taxed.

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# Business Income Vs. Capital Gains

## Tax Consequences Of Classification

6-28. The tax consequences associated with the classification of a disposition as a capital transaction vs. a business income transaction can be described as follows:

- Only one-half of a capital gain is taxed and only one-half of a capital loss is deductible. If a gain transaction can be classified as capital in nature, the savings to the taxpayer is very significant. Alternatively, if a loss is involved, classification as a capital transaction reduces the value of this loss by one-half.
- Allowable capital losses (i.e., the deductible one-half) can only be deducted against taxable capital gains (i.e., the taxable one-half). This can be of great importance, particularly to individual taxpayers and smaller business enterprises. It may be years before such taxpayers realize taxable capital gains, resulting in a situation where there is significant deferral of the tax benefits associated with allowable capital losses.

6-29. These are, of course, very significant tax consequences. Not surprisingly, this has resulted in thousands of disputes related to this classification, many of which wind up in the various levels of our court system.

## Capital Gains Defined

6-30. The business income vs. property income issue arises while an asset is being held. Using the criteria discussed in the previous section, during the period of ownership the taxpayer must determine whether the income that is produced by the asset is business income or, alternatively property income.

6-31. In contrast, the business income vs. capital gains issue is only applicable when there is a disposition of an asset. If the disposition is of a non-depreciable capital asset, the result will be a capital gain or loss. If the asset is a depreciable capital asset, no capital loss can occur and there may be other outcomes such as recapture of CCA or a terminal loss. If the disposition is of an asset that is not capital or personal in nature, the result will be business income or loss.

6-32. The basic concept is a simple one — capital assets are acquired and held to produce income through their use. If an asset is acquired not to be held but, rather, to be resold for a profit, it is not a capital asset.

6-33. As a simple example, consider the assets of a retail store. These will include inventories of purchased merchandise that are being held for resale. Such assets are not part of the capital assets of the business, and any income related to their sale would be classified as business income. However, the building in which the merchandise is being offered for sale, as well as the furniture and fixtures necessary to the operation of the business, are capital assets. This would mean that if the operation were to sell these assets for more than their capital cost, any resulting gain would be capital in nature.

6-34. In a general manner, capital assets are somewhat analogous to the accounting classification of non-current assets, while non-capital assets are somewhat analogous to the accounting classification of inventories.

6-35. An additional analogy, sometimes applied in court cases, is with a fruit bearing tree. The tree itself is a capital asset and its sale would result in a capital gain or loss. In contrast, the sale of the fruit from the tree would generate business income.

6-36. The actual use of the asset often determines the appropriate classification. A particular type of asset can be classified as capital by one business and as inventory by another. Consider a piece of equipment such as a backhoe. For a construction company using this asset for excavating construction sites, it would clearly be a capital asset. Alternatively, if it were held for sale by a dealer in construction equipment, it would be classified as inventory, with any gain on its sale being taxed as business income.

6-37. It should be noted that you cannot always equate capital property with income producing property. Consider a real estate developer who is holding an inventory of properties for sale. If he chooses to rent some of these properties on a short term basis, they would be producing income. However, this would not alter the fact that the developer's primary intent is to sell these properties, making inventory the appropriate classification.

## Criteria For Identifying Capital Gains

### *Primary And Secondary Intention*

6-38. As implied in the previous discussion, the determination of whether a property is a capital property is based on the intent of the taxpayer when the asset was acquired. If his primary intention was to use the property to produce income it is a capital property and its disposition will result in a capital gain or capital loss. If the intent was to resell the property as quickly as possible, its disposition will result in business income.

6-39. There may be situations where a property is originally acquired for income producing purposes but is sold because the acquirer's primary goal cannot be met. It is possible to argue

that the taxpayer's secondary intention was to sell in the event his primary intention was frustrated.

6-40. Unfortunately, only the taxpayer has unequivocal knowledge of his intention at the time a property is acquired. Because of this, other, more objectively measurable factors have to be considered in making this determination.

### *Other Considerations*

6-41. Other factors that have been considered in attempting to establish whether an asset should be considered capital property include the following:

> **Length Of The Ownership Period** The longer the period of ownership, the more likely it is that the taxpayer's intent was to hold the asset to produce income.
>
> **Number And Frequency Of Transactions** A large number of closely spaced transactions in a given period of time would be an indication that the investor was in the business of dealing in this type of asset, not holding it to produce income.
>
> **Relationship To The Taxpayer's Business** If the transaction is related to the taxpayer's business, this may be sufficient to disqualify any gain or loss from capital gains treatment. For example, a gain on a mortgage transaction might be considered business income to a real estate broker.
>
> **Supplemental Work On The Property** Additional work on the property, directed at enhancing its value or marketability, would indicate an adventure in the nature of trade resulting in business income.
>
> **Nature Of The Assets** The conventional accounting distinction between fixed assets and working capital has been used in some cases to determine whether income was business or capital in nature. Also, whether the asset is capable of producing income would be a consideration.

6-42. For more specific guidance with respect to transactions in securities, IT-479R, "Transactions In Securities" provides a list of factors that the courts have considered in making the capital gains/business income distinction. A similar list for the classification of real estate transactions can be found in IT-218R, "Profit, Capital Gains And Losses From The Sale of Real Estate, Including Farmland And Inherited Land And Conversion Of Real Estate From Capital Property To Inventory And Vice Versa".

### Exercise Six - 2

**Subject:** Business Income Vs. Capital Gain

During 2019, Sandra Von Arb acquired a four unit apartment building for $230,000. While it was her intention to operate the building as a rental property, one month after her purchase she received an unsolicited offer to purchase the building for $280,000. She accepts the offer. Should the $50,000 be treated as a capital gain or as business income? Justify your conclusion.

**SOLUTION available in print and online Study Guide.**

## Business Income And GAAP

6-43. Financial statements requiring audit opinions must be prepared in accordance with generally accepted accounting principles, or GAAP. These principles have had a significant influence on the development of the tax concept of business income. This is reflected in the fact that, for tax purposes, business income is usually an accrual, rather than a cash based calculation. Further, it is a net rather than a gross concept. In addition, GAAP continues to be

influential in that income as computed under these principles is usually required for tax purposes, unless a particular provision of the *Act* specifies alternative requirements.

6-44. This means that business income under the *Income Tax Act* will not be totally unfamiliar to anyone who has had experience in applying GAAP. However, there are a number of differences between GAAP based Net Income and net business income for tax purposes. While many of these will become apparent as we cover specific provisions of the *Act*, it is useful to note some of the more important differences at this point. They are as follows:

**Amortization (Depreciation)** As was noted in Chapter 5, the *Income Tax Regulations* provide the methods and rates to be used in determining the maximum CCA that can be deducted in a given taxation year. However, there is no requirement that this maximum amount be deducted, nor is there any requirement that a consistent policy be followed as long as the annual amount involved is no greater than the maximum amount specified in the *Act*. In contrast, GAAP allows management to choose from a variety of amortization methods. However, once a method is adopted, it must be used consistently each year to deduct the full amount as calculated by that method.

Because of these different approaches, CCA deducted will be different and usually larger, than the corresponding amortization expense under GAAP. This is the most common and, for most enterprises, the largest difference between accounting Net Income and Net Income For Tax Purposes.

**Other Allocations** There are other items, similar to amortization charges, where the total cost to be deducted will be the same for tax and accounting purposes. However, they will be deducted using different allocation patterns. Examples would be pension costs (funding payments are deducted for tax purposes) and warranty costs (cash payments are deducted for tax purposes).

**Permanent Differences** There are some differences between tax and accounting income that are permanent in nature. For example, 100 percent of capital gains are included in accounting Net Income, while only one-half of this income is included in Net Income For Tax Purposes. Other examples of this type of difference would be the non-deductible 50 percent of business meals and entertainment and the non-deductible portion of automobile lease payments (see discussion later in this Chapter).

**Unreasonable Expenses** In applying GAAP, accountants are generally not required to distinguish between expenses that are reasonable and those that are not. If assets were used up in the production of revenues of the period, they are expenses of that period. This is not the case for tax purposes. ITA 67 indicates that only those expenditures that may be considered reasonable in the circumstances may be deducted in the computation of Net Income For Tax Purposes. If, for example, a large salary was paid to a spouse or to a child that could not be justified on the basis of the services provided, the deduction of the amount involved could be disallowed under ITA 67. The fact that this salary could be deducted in the determination of accounting Net Income would not alter this conclusion.

**Non-Arm's Length Transactions** ITA 69 deals with situations involving transactions between non-arm's length parties and provides special rules when such non-arm's length transactions take place at values other than fair market value (see Chapter 9 for a complete discussion of these rules). For example, if a taxpayer acquired an asset with a fair market value of $2,000 from a related party for $2,500 (a value in excess of its fair market value), the transferee is deemed to have acquired it at its fair market value of $2,000, while the transferor is taxed on the basis of the $2,500 consideration received. If the transferee was a business, no similar adjustment would be required under GAAP. Note, however, there are requirements under GAAP for disclosing related party transactions.

6-45. As many of you are aware, the financial reporting rules applicable to accounting for taxes focus on temporary differences. GAAP defines these differences with reference to Balance Sheet items. However, in determining business income (for tax purposes), the normal

approach is to reconcile accounting Net Income with Net Income For Tax Purposes. As a consequence, individuals working in the tax area focus on Income Statement differences, as opposed to Balance Sheet differences.

# Business Income - Inclusions (Revenues)

## Inclusions In Business Income - Income Tax Act Provisions

### *ITA 12*

6-46. In subdivision b of the *Income Tax Act*, inclusions in business and property income are covered in Sections 12 through 17.1. The focus in this Chapter will be on Section 12 where we find the tax treatment of most of the items that we commonly think of as operating revenues for a business.

6-47. We would note, however, that ITA 12(1)(c) deals with interest income and ITA 12(1)(j) and (k) deal with dividends received. As these inclusions most commonly relate to property income, they will be discussed in Chapter 7, Income From Property.

6-48. In addition, ITA 12(1)(l) requires the inclusion of business and property income from a partnership, and ITA 12(1)(m) requires the inclusion of benefits from trusts. These inclusions will be dealt with in Chapters 18 and 19 which deal, respectively, with partnerships and trusts.

### *ITA 13 Through 17*

6-49. Section 13 which deals with depreciable property issues was largely covered in Chapter 5. Section 15, which deals with benefits conferred on shareholders of corporations, will be covered in Chapter 15, Corporate Taxation And Management Decisions. None of the other ITA 13 through 17 Sections will be given coverage in this text.

## Amounts Received And Receivable

6-50. The most important inclusion in business income is found in ITA 12(1)(b) which requires the inclusion of amounts that have become receivable during the year for property sold or services rendered. This provision clearly establishes that, in general, business income is determined on an accrual basis.

6-51. ITA 12(1)(b) also notes that amounts generally become receivable on the day on which goods are delivered or services rendered. This is consistent with the accountant's point of sale approach to revenue recognition.

6-52. However, in a departure from the usual GAAP definition of revenue, ITA 12(1)(a) requires the inclusion of amounts received for goods to be delivered in the future. Under GAAP such advances from customers are treated as a liability, rather than as a revenue. While this would appear to create a difference between accounting Net Income and business income for tax purposes, we will find that this difference is eliminated through the use of a reserve for undelivered goods.

6-53. In the next section of this Chapter we will examine how reserves are used to modify the amount of revenues recorded under ITA 12(1)(a) and (b). While, at first glance, these procedures are somewhat different than those used under GAAP, they will generally result in a final inclusion that is identical to the amount of revenue that is recognized under GAAP.

## Reserves

### *The General System*

6-54. In tax work, the term "reserve" is used to refer to a group of specific items that can be deducted in the determination of net business income. Unlike most deductions that relate either to cash outflows or the incurrence of liabilities, these items are modifications of amounts received (reserve for undelivered goods) or amounts receivable (reserve for doubtful debts and reserve for unpaid amounts).

6-55. With respect to the use of such reserves, the basic rules are as follows:

**Deductible Reserves** ITA 18(1)(e) indicates that a particular reserve cannot be deducted unless it is specifically provided for in the *Act*. This means that, for example, when estimated warranty costs are deducted as an accounting expense in the year in which the related product is sold, no reserve can be deducted for tax purposes, as a reserve for estimated warranty costs is not specified in the *Act*. Note that while ITA 20(1)(m.1) does refer to a manufacturer's warranty reserve, careful reading shows that amounts can only be deducted under this provision when they are for an extended warranty covered by an insurance contract.

**Addition To Income** When a reserve is deducted in a particular taxation year, it must be added back to income in the immediately following year. These additions are required under various Paragraphs in ITA 12 [e.g., ITA 12(1)(d) requires the addition of reserves deducted for doubtful debts in the preceding year].

6-56. The most common reserves that are specified in the *Income Tax Act* as deductions from business income are as follows:

- ITA 20(1)(l) - **Reserve For Doubtful Debts (Bad Debts)**
- ITA 20(1)(m) - **Reserve For Undelivered Goods And Services**
- ITA 20(1)(n) - **Reserve For Unpaid Amounts**

6-57. The details of these reserves will be covered in the following material.

### *Reserve For Doubtful Debts - ITA 20(1)(l)*

6-58. While specific tax procedures for dealing with bad debts differ from those used under GAAP, these alternative procedures will normally produce identical results. The required tax procedures are as follows:

- Under ITA 20(1)(l), a year end deduction is permitted for an estimate of the bad debts that will be realized subsequent to the current year.
- During the subsequent year, actual bad debts may be deducted under ITA 20(1)(p).
- At the end of this subsequent year, the old reserve must be included in business income under ITA 12(1)(d). A new reserve is established under ITA 20(1)(l).

**EXAMPLE** On December 31, 2018, at the end of its first year of operations, Ken's Print Shop estimates that $5,500 of its ending Accounts Receivable will be uncollectible. For 2018, an Allowance For Bad Debts is established for this amount for accounting purposes (by debiting Bad Debt Expense and crediting Allowance For Bad Debts). For tax purposes, a reserve of $5,500 is deducted under ITA 20(1)(l). During the year ending December 31, 2019, $6,800 in accounts receivable are written off. At December 31, 2019, estimated uncollectible accounts total $4,800.

6-59. For accounting purposes, the 2018 estimate of bad debts would be charged to expense and credited to an Allowance For Bad Debts (a contra account to Accounts Receivable). For tax purposes, the same amount would be deducted from net business income as a Reserve For Doubtful Debts.

6-60. During 2019, the accountant for Ken's Print Shop would credit Accounts Receivable and debit Allowance For Bad Debts for the actual write offs of $6,800. This would leave a debit (negative) balance in this account of $1,300 ($5,500 - $6,800), indicating that the 2018 estimate was too low. This error would be corrected by adding the $1,300 to the Bad Debt Expense for 2019. The total expense for 2019 would be as follows:

| | |
|---|---|
| 2019 Estimate Of Future Bad Debts (Credit Allowance) | $4,800 |
| Increase In Expense To Eliminate Debit Balance In Allowance | 1,300 |
| 2019 Bad Debt Expense For Accounting Purposes | $6,100 |

6-61. For tax purposes, the total Bad Debt Expense would be the same $6,100. However, the calculation follows a different pattern:

| | | |
|---|---|---|
| Add: 2018 Reserve For Tax Purposes | | $ 5,500 |
| Deduct: | | |
| 2019 Actual Write-Offs | ($6,800) | |
| 2019 Reserve For Tax Purposes | ( 4,800) | ( 11,600) |
| 2019 Net Deduction For Tax Purposes | | ($ 6,100) |

## Exercise Six - 3

**Subject:** Bad Debts And Reserve For Doubtful Accounts

On December 31, 2018, Norman's Flowers estimates that $16,000 of its ending Accounts Receivable will be uncollectible. A reserve for this amount is deducted for tax purposes. During the year ending December 31, 2019, $17,200 in bad accounts are written off. At December 31, 2019, estimated uncollectible accounts total $18,400. What is the 2019 Bad Debt Expense for accounting purposes? By what amount will the 2019 net business income (for tax purposes) of Norman's Flowers be increased or decreased by the preceding information with respect to bad debts?

**SOLUTION available in print and online Study Guide.**

### *Reserve For Undelivered Goods And Services - ITA 20(1)(m)*

6-62. It was previously noted that, unlike the situation under GAAP, amounts received for goods or services to be delivered in the future must be included in the calculation of revenues for tax purposes. However, this difference is offset by the ability to deduct, under ITA 20(1)(m), a reserve for goods and services to be delivered in the future. This means that, while the procedures are somewhat different, the treatment of amounts received for undelivered goods and services is the same under both the *Income Tax Act* and GAAP.

**EXAMPLE** During the taxation year ending December 31, 2019, Donna's Auto Parts has receipts of $275,000. Of this amount, $25,000 is a prepayment for goods that will not be delivered until 2020.

**ANALYSIS** While the $275,000 will be considered an inclusion in 2019 net business income, Donna will be able to deduct a reserve of $25,000 under ITA 20(1)(m). This $25,000 amount will be added back to her 2020 net business income, reflecting the fact that the goods have been delivered and the revenue realized.

## Exercise Six - 4

**Subject:** Reserve For Doubtful Accounts And Undelivered Services

As an unincorporated business, Barbra's Graphic Design keeps its records on a cash basis. During 2019, its first year of operation, the business has cash sales of $53,400. At the end of the year, an additional $26,300 of revenues was receivable. Of the amounts received, $5,600 was for services that will be delivered during 2020. Barbra estimates that $425 of the end of year receivable amounts will be uncollectible. By what amount will the 2019 net business income of Barbra's Graphic Design be increased by the preceding information?

**SOLUTION available in print and online Study Guide.**

### Reserve For Unpaid Amounts - ITA 20(1)(n)

6-63. If a business sells goods with the amount being receivable over an extended period (i.e., instalment sales), ITA 20(1)(n) permits the deduction of a reasonable reserve in very specific circumstances. The calculation of the reserve is based on the gross profit on the sale. Note that this reserve is only available on business income and should not be confused with capital gains reserves which are covered in Chapter 8. While this appears to provide for the recognition of revenue on a cash basis, there are two significant constraints:

**ITA 20(1)(n)** indicates that no reserve can be deducted unless at least some part of the proceeds will not be received until at least two years after the date the property is sold (this two year requirement does not apply to sales of real property inventory).

**ITA 20(8)** specifies that no reserve can be deducted in a year, for any type of property, if the sale took place more than 36 months before the end of that year (i.e., the reserve is limited to a maximum of 3 years). In addition, the reserve is not available if the purchaser is a corporation controlled by the seller, or a partnership in which the seller has a majority interest.

## Exercise Six - 5

**Subject:** Reserve For Unpaid Amounts

During November, 2019, Martine's Jewels Ltd. sells a necklace for $120,000. The cost of this necklace was $55,000, resulting in a gross profit of $65,000. The $120,000 sales price is to be paid in four equal annual instalments on December 31 in each of the years 2020 through 2023. Martine's Jewels Ltd. has a December 31 year end. Indicate the amount of the reserve that can be deducted, and the net business income, for each of the years 2019 through 2023.

**SOLUTION available in print and online Study Guide.**

**We suggest you work Self Study Problems Six-1 and Six-2 at this point.**

## Other Inclusions

6-64. There are a number of other inclusions in business income. While some are of only limited interest in a text such as this [e.g., ITA 12(1)(z.4) requires the inclusion of eligible funeral arrangements], some of these inclusions warrant additional comment. Income Tax Folio S3-F9-C1, *Lottery Winnings, Miscellaneous Receipts, and Income (and Losses) from Crime* provide some coverage of the following, as well as coverage of other miscellaneous receipts:

**Crowdfunding** Crowdfunding is the collection of funds from a large number of small contributors, usually online by means of a web platform. This is a relatively new source of funds that has been successfully used for a variety of purposes, including developing a new product. In a technical Interpretation 2013-0484941E5, the CRA has indicated that non-equity funds derived from a crowdfunding campaign are generally taxable as business income under ITA 9(1). Given this, the costs of mounting the crowdfunding campaign would be deductible against the income derived.

Income Tax Folio S3-F9-C1 includes this conclusion in an example under the section "Gifts and other voluntary payments". It is likely that there will be more consideration of this issue, particularly in situations where equity shares are issued to the crowdfunding contributors.

**Profits From Gambling** Profits derived from bookmaking or from the operation of any legal or illegal gambling establishment constitute income from a business. An individual's gambling activities, if extensive enough, could constitute a business (e.g., a professional poker player). In this case such income would be taxable and it would suggest that losses would be fully deductible.

**Lottery Schemes** In general, the amount or value of a prize received by a taxpayer from a lottery scheme is not taxable as either a capital gain or income.

**Profits From An Illegal Business** Many people are aware that the famous American gangster Al Capone was sent to jail, not for his illegal activities involving alleged robbery and murder, but rather for his failure to pay taxes on the resulting profits. As illegal revenues must be included in business income, related expenses are generally deductible. This can lead to interesting conclusions as evidenced by a publication of the New Zealand Inland Revenue Department. This publication provided a detailed list of items that could be deducted by what was referred to as "sex workers". Without going into detail, we would note that see-through garments and whips were on the list, provided they were used in delivering services to a client.

6-65. Other inclusions in business income that are not covered in IT Folio S3-F9-C1 include the following:

**Damage Payments Received** Damages are usually received as the result of non-performance of a contractual arrangement. Their tax treatment depends on what the damage award is intended to replace. If it replaces revenue that would have been included in income, then the award is income. If it is compensation for damages to reputation, organization, or structure, it may be considered a tax free capital receipt.

**Debt Forgiveness** Situations arise in which outstanding debt is forgiven, often by a related taxpayer. When this happens, ITA 80 contains a complex set of rules that apply when the debtor has been able to deduct the interest expense on the forgiven debt. These rules may require the amount of debt forgiven to be applied to reduce loss carry over balances, the tax cost of certain properties and, in some situations, to be included in income in the year of forgiveness. The details of these rules are beyond the scope of this text.

**Government Assistance** Whether or not government assistance will be included in current income depends on the nature of the assistance. The tax rules here largely reflect the accounting rules that are found in GAAP. That is, assistance related to current revenues and expenses will be included in current income while, in contrast, assistance related to the acquisition of capital assets will be deducted from the cost of these assets.

**Inducement Receipts** Businesses may receive payments that induce them to undertake some activity. An example of this would be a payment received by a lessor to induce him to undertake improvements to the leased property. The taxpayer has several alternatives here. The amount received can be included in current income, used to reduce the cost of any related assets, or used to reduce any required expenses. These are the same alternatives that are available under GAAP.

**Restrictive Covenant Receipts** A restrictive covenant is an agreement entered into, an undertaking made, or a waiver of an advantage or right by a taxpayer. ITA 56.4 would, in general, require that these payments be included in income. There are a limited number of exceptions, one of which would allow the receipt to be allocated to cumulative eligible capital.

# Limitations On Deductions From Business And Property Income

## General Approach - Restrictions In ITA 18 Through ITA 19.1

6-66. It would be extremely difficult to provide a detailed list of all of the items that might possibly be considered a business expense. While ITA 20 spells out many such items, it is often necessary to have more general guidance when new types of items arise. ITA 18 through ITA 19.1 gives this guidance in a somewhat backwards fashion by providing guidelines on what should not be deducted in computing business income. However, this negative guidance frequently provides assistance in determining what should be deducted in computing business income.

6-67. Note, however, that if an item is specifically listed in the *Act* as a deduction, the specific listing overrides the general limitation. For example:

> **Capital Cost Allowance (CCA)** Section 18(1)(b) prohibits the deduction of capital costs. However, this general provision is over-ridden by ITA 20(1)(a) which provides the deduction of CCA.

> **Landscaping Costs** As previously noted, ITA 18(1)(b) prohibits the deduction of capital costs. This general provision is also over-ridden by ITA 20(1)(aa) which permits the deduction of landscaping costs, some of which would be capital expenditures.

6-68. The restrictions contained in ITA 18 through ITA 19.1 apply only to deductions from business and property income. There are other restrictions, for example the cost of business meals and entertainment, which apply to deductions from both business and property income, as well as to deductions from employment income. Most of these more general restrictions are found in Subdivision f, "Rules Relating To Computation Of Income", and are discussed later in this Chapter.

## Specific Limiting Items Under ITA 18

### *Incurred To Produce Income*

6-69. One of the most important of the limiting provisions is as follows:

> **ITA 18(1)(a)** No deduction shall be made in respect of an outlay or expense except to the extent that it was made or incurred by the taxpayer for the purpose of gaining or producing income from the business or property.

6-70. When there is a question as to the deductibility of an item not covered by a particular provision of the *Act*, it is usually this general limitation provision that provides the basis for an answer. As a consequence, there are many Interpretation Bulletins dealing with such matters as motor vehicle expenses (IT-521R). IT Folio S4-F2-C1, *Deductibility Of Fines Or Penalties* and S4-F2-C2, *Business Use of Home Expenses* also deal with this issue. In addition, there have been hundreds of court cases dealing with particular items. For example, with respect to insurance costs, there have been cases in the following areas:

- Damage insurance on business assets (deductible)
- Life insurance when required by creditor (deductible, if interest on loan is deductible)
- Life insurance in general (not deductible)
- Insurance against competition (deductible)

6-71. As can be seen from the preceding list, this is a complex area of tax. If there is doubt about a particular item's deductibility, it will sometimes be necessary to do considerable research to establish whether it is dealt with in an Interpretation Bulletin or a court case.

6-72. In applying this provision, it is not necessary to demonstrate that the expenditure actually produced income. It is generally sufficient to demonstrate that it was incurred as part of an income earning process or activity.

## Capital Expenditures

6-73. ITA 18(1)(b) prohibits the deduction of any expenditure that is designated as a capital expenditure. However, deductions are permitted under ITA 20(1)(a) for capital cost allowances. The limitations on this deduction were discussed in detail in Chapter 5.

## Exempt Income Expenditures

6-74. ITA 18(1)(c) prohibits the deduction of any expenditures that were incurred to produce income that is exempt from taxation. For a business, this would have limited applicability as few sources of business income are tax exempt.

## Personal And Living Expenses

6-75. ITA 18(1)(h) prohibits the deduction of an expenditure that is a personal or living expense of the taxpayer. This means that the cost of personal travel for a self employed contractor is not deductible Or if, for example, a corporation pays for the personal travel of a shareholder, the corporation cannot deduct the costs. Note, however, if a corporation pays for the personal travel of an arm's length employee, this provision is not applicable and the costs would be deductible as the travel costs are not personal expenses of the corporation.

6-76. This can create a very unfortunate tax situation if a corporation pays for personal and/or living expenses of non-employee shareholders and employee shareholders where the payment of personal expenses has nothing to do with employment. Not only will the costs of such expenses be non-deductible to the business, the shareholder will have to include the value of the expense in their income as a shareholder benefit. Clearly, it would be preferable to simply pay additional salary equal to the value of the expenditure. Using this alternative, the tax consequences to the employee or shareholder would be the same. However, the business would benefit from being able to deduct the amount paid.

6-77. Somewhat indirectly, ITA 18(1)(h) introduces an additional rule with respect to the deductibility of costs. The ITA 248(1) definition of "personal or living expenses" indicates that the expenses of properties maintained for the use of an individual or persons related to that individual are personal unless the properties maintained are connected to a business that is either profitable, or has a reasonable expectation of being profitable. This could result in some deductions being denied for a cottage that was rented during the year, but was used by the taxpayer for a part of that year.

## Deferred Income Plans

6-78. ITA 18(1)(i) restricts the deductibility of contributions under supplementary unemployment benefit plans to the amount specified in ITA 145. ITA 18(1)(j) and 18(1)(k) provide similar limitations for contributions to deferred profit sharing plans and profit sharing plans. ITA 18(1)(o) prohibits the deduction of contributions to an employee benefit plan. Finally, under ITA 18(1)(o.1) and (o.2), limits are placed on the deductibility of amounts paid to salary deferral arrangements and retirement compensation arrangements. These amounts are only deductible as specified under ITA 20(1)(r) and (oo). All of these provisions are discussed in detail in Chapter 10, Retirement Savings And Other Special Income Arrangements.

## Recreational Facilities And Club Dues

6-79. ITA 18(1)(l) prohibits the deduction of amounts that have been incurred to maintain a yacht, camp, lodge, golf course or facility, unless the taxpayer is in the business of providing such property for hire. Because of the fairly specific wording of this provision, it would appear that the costs of providing other types of recreational benefits would be deductible. For example, a corporation could deduct the costs of providing a general fitness center for their employees, provided it was made available to all employees.

6-80. A similar prohibition is made against the deduction of membership fees or dues to dining, sporting, or recreational facilities. Note, however, that there is no prohibition against deducting the cost of legitimate entertainment expenses incurred in such facilities, subject to the 50 percent limitation that will be described shortly.

### Political Contributions

6-81. ITA 18(1)(n) prohibits the deduction of political contributions in the determination of business or property income. Given the restrictions on making of political contributions that are found in the *Canada Elections Act*, this is not a costly provision for business. As covered in Chapter 4, this *Act* limits individual contributions to an annual amount of $1,600 (for 2019) for a party or contestant and completely prohibits contributions by corporations.

### Expenses Of A Personal Services Business

6-82. A personal services business is a corporation that has been set up by an individual to provide personal services that are, in effect, employment services. ITA 18(1)(p) restricts the deductible expenses of such a corporation to those that would normally be deductible against employment income. Chapter 12, Taxable Income And Tax Payable For Corporations, provides coverage of this subject.

### Automobile Mileage Payments

6-83. As is discussed in Chapter 3, a business may pay its employees or shareholders a per kilometer fee for having them use their own automobile on behalf of the business. The amount of such payments that can be deducted by a business is limited by ITA 18(1)(r) to an amount prescribed in ITR 7306. For 2019, this amount is 58 cents for the first 5,000 kilometers and 52 cents for additional kilometers driven by an employee.

6-84. Amounts paid in excess of these limits will only be deductible to the payer to the extent that they are included in the income of the recipient.

### Interest And Property Taxes On Land

6-85. Many businesses pay interest and property taxes on land. If the primary purpose of holding this land is to produce income, these payments clearly represent amounts that can be deducted as part of the costs of carrying the land while it is producing income.

6-86. In contrast, when vacant land is generating insignificant amounts of income, ITA 18(2) restricts the deduction for property taxes and interest to the amount of net revenues produced by the land. For example, if a parcel of land that is being held as a future plant site is generating some revenue by being rented for storage, interest and property taxes on the land can only be deducted to the extent of the net revenues from the rent. ITA 53(1)(h) allows the undeducted interest and property taxes to be added to the adjusted cost base of the property, thereby reducing any future capital gain resulting from the disposition of the property. This addition to the adjusted cost base is only available if the primary purpose of holding the land is to produce income. There is, however, no requirement that income be produced in a given year.

6-87. In the case of land that is being held as inventory, ITA 10(1.1) permits the non-deductible interest and property taxes to be added to the cost of the land.

6-88. The preceding general rules could be viewed as too restrictive for those companies whose "principal business is the leasing, rental or sale, or the development for lease, rental or sale, of real property". As a consequence, these real estate companies are allowed to deduct interest and property tax payments to the extent of net revenues from the property, plus a "base level deduction".

6-89. This base level deduction is defined in ITA 18(2.2) as the amount that would be the amount of interest, computed at the prescribed rate, for the year, in respect of a loan of $1,000,000 outstanding throughout the year. This means that, if the prescribed rate for the year was 2 percent, real estate companies could deduct interest and property taxes on the land that they are carrying to the extent of net revenues from the land, plus an additional $20,000 [(2%)($1,000,000)].

### Soft Costs

6-90. Costs that are attributable to the period of construction, renovation, or alteration of a building, or in respect of the ownership of the related land, are referred to as soft costs. These

costs could include interest, legal and accounting fees, insurance, and property taxes. In general, ITA 18(3.1) indicates that such costs are not deductible and must be added to the cost of the property.

## Appraisal Costs

6-91. While these costs are not covered in ITA 18, there are limitations on their deductibility that are discussed in IT-143R3, *Meaning Of Eligible Capital Expenditures*. As discussed in that Bulletin, the treatment of appraisal costs on capital property will depend on the reason for their incurrence:

- If they are incurred on a capital property for the purpose of its acquisition or disposition, they are generally added to the cost of the property.
- If they are incurred with respect to a proposed acquisition that does not take place, they should be treated as eligible capital expenditures (see Byrd/Chen Note).
- If they are incurred for the purpose of gaining or producing income from a business (e.g., the cost of an appraisal required for insurance purposes), they are deductible in computing income for the year.

**BYRD/CHEN NOTE** While items that were previously viewed as eligible capital expenditures are allocated to Class 14.1, a regular CCA Class, IT-143R3 is still in effect. This means that the preceding guidance on the treatment of appraisal costs would still be appropriate. The only difference is with respect to the second bullet. Appraisal costs that are incurred with respect to a proposed acquisition that does not take place will be treated as an addition to Class 14.1.

## Interest In Thin Capitalization Situations

6-92. In general, interest paid on debt is deductible to a business, whereas dividends paid on outstanding shares are not. Given this, there is an incentive for a non-resident owner of a Canadian resident corporation to take back debt rather than equity for the financing that he provides to the corporation. This could result in a situation where the payment of the interest is deductible in Canada and, at the same time, is not taxable to the non-resident recipient due to an international tax treaty (see Chapter 20).

6-93. To prevent this from happening, ITA 18(4) through 18(6) limit the deductibility of interest paid in such "thin capitalization" situations. Interest paid or payable to the non-resident specified shareholder is disallowed as a deduction if it is paid on amounts of debt in excess of 1.5 times the sum of the shareholder's share of contributed capital, plus 100 percent of the corporation's Retained Earnings at the beginning of the year. In conjunction with this, ITA 214(16) re-characterizes the interest as a non-deductible dividend (as discussed in Chapter 20, this will result in Canadian taxes being withheld from the distribution to the non-resident). For this purpose, a specified shareholder is defined in ITA 18(5) as a person who holds shares that give him 25 percent or more of the votes that would be cast at the annual meeting of the shareholders, or 25 percent or more of the fair market value of all issued and outstanding shares. A simple example will serve to clarify these rules:

**EXAMPLE** Throughout 2019, Mr. Lane, a resident of the U.S., owns 45 percent of the shares and holds $3,000,000 of the long-term debt securities of Thinly Ltd. The capital structure of Thinly Ltd. throughout the year is as follows:

| | |
|---|---|
| Long-Term Debt (11% Rate) | $5,000,000 |
| Common Stock | 200,000 |
| Retained Earnings | 300,000 |
| Total Capital | $5,500,000 |

**ANALYSIS** Mr. Lane is clearly a specified shareholder as he holds 45 percent of the corporation's shares. His relevant equity balance is $390,000 [(45%)($200,000) + (100%)($300,000)]. His debt holding is clearly greater than 1.5 times this relevant equity balance. As a consequence, there would be disallowed interest of $265,650 calculated as follows:

| | |
|---|---|
| Total Interest Paid To Mr. Lane [(11%)($3,000,000)] | $330,000 |
| Maximum Deductible Interest [(11%)(1.5)($390,000)] | ( 64,350) |
| Disallowed Interest (Re-Characterized As A Dividend) | $265,650 |

## Exercise Six - 6

**Subject:** Interest In Thin Capitalizations

On January 1, 2018, a new Canadian corporation is formed with the issuance of $8,600,000 in debt securities and $2,400,000 in common shares. On this date, Ms. Sally Johnson, who is a resident of Mexico, acquires $4,500,000 of the debt securities and 30 percent of the common shares. The debt securities pay interest at 9 percent. The company has a December 31 year end. On January 1, 2019, the Retained Earnings balance of the company is $900,000. How much, if any, of the interest paid on Ms. Johnson's holding of debt securities during 2019 would be disallowed under the thin capitalization rules in ITA 18(4)?

**SOLUTION available in print and online Study Guide.**

### *Prepaid Expenses*

6-94. ITA 18(9) prevents the deduction of amounts that have been paid for goods or services that will be delivered after the end of the taxation year. This Subsection also prohibits the deduction of interest or rents that relate to a subsequent taxation year. As a result, the tax treatment of these items is the same as their treatment under GAAP.

### *Business Use Of Home Expenses (Work Space In The Home Costs)*

6-95. The rules related to the use of a home office to earn business income are found in ITA 18(12). Guidance for the application of these rules is found in IT Folio S4-F2-C2, *Business Use Of Home Expenses*. As was the case when a home office was used for earning employment income, the deductibility of related expenses is limited to situations where:

- the work space is the individual's principal place of business; or
- the work space is used exclusively for the purpose of earning income from business and is used on a regular and continuous basis for meeting clients, customers, or patients of the individual.

6-96. If an individual qualifies for this deduction because it is his principal place of business, the space does not have to be used exclusively for business purposes. If, for example, a dining room table is used to run a mail order business and that room qualifies as the principal place of business for the operation, work space in the home costs can be deducted for the dining room space. Note, however, that in determining the appropriate amount of costs, consideration would have to be given to any personal use of that space.

6-97. If the work space is not the principal place of business, it must be used exclusively for the purpose of earning income. This requires that some part of the home must be designated as the home work space and not be used for any other purpose. In addition, this second provision requires that the space be used on a regular and continuous basis for meeting clients, customers, or patients. IT Folio S4-F2-C2 indicates that a work space for a business that normally requires infrequent meetings, or frequent meetings at irregular intervals, would not meet this requirement.

6-98. When the conditions for deductibility are met, expenses must generally be apportioned between business and non-business use in a reasonable manner, usually on the basis of floor space used. Maintenance or repair expenses that relate directly to the area being used for business can be deducted in full. Figure 6-2 (following page) compares the deductibility of work space in the home costs for an employee with no commission income, an employee with commission income and a self-employed individual earning business income.

**Figure 6 - 2**
**Deductibility Of Work Space In The Home Costs**

| | Employee - No Commissions | Employee - With Commissions | Self-Employed Business Income |
|---|---|---|---|
| Rent (if tenant) | Yes | Yes | Yes |
| Utilities | Yes | Yes | Yes |
| Repairs, Maintenance | Yes | Yes | Yes |
| Telephone (Supply)* | **NO**/Yes | **NO**/Yes | Yes |
| Internet (Supply)* | **NO** | **NO** | Yes |
| Property Taxes | **NO** | Yes | Yes |
| Home Insurance | **NO** | Yes | Yes |
| Mortgage Interest | **NO** | **NO** | Yes |
| CCA On House | **NO** | **NO** | Yes |

*Employees cannot deduct the monthly basic cost of a home telephone or the cost of fees for home internet service. Long distance charges that reasonably relate to employment income are deductible. In contrast, to the extent that telephone and internet service at an individual's home is used for both business and personal purposes, the business portion of the expense are deductible. A reasonable basis of proration should be used.

6-99. You will note in Figure 6-2 that individuals earning business income can deduct CCA on their home. While this deduction would result in a lower Taxable Income for the current year, tax professionals generally advise people not to make this deduction. The reason for this relates to the fact that gains on an individual's principal residence can generally be received on a tax free basis (see Chapter 8 for a full discussion of the principal residence exemption). If an individual deducts CCA on this property as a self-employed individual, the result can be that part of the gain on the sale of the residence will be taxable. This assumes that relevant real estate prices are increasing.

6-100. Regardless of the types of costs deducted, work space in the home costs cannot create or increase a business (or employment) loss. As a result, the total deduction will be limited to the amount of net business income calculated without reference to the work space in the home costs. Any expenses that are not deductible in a given year because they exceed the business income in that year can be carried forward and deducted in a subsequent year against income generated from the same business. In effect, there is an indefinite carry forward of unused work space in the home costs. This carry forward is conditional on the work space continuing to meet the test for deductibility in future years.

## Exercise Six - 7

**Subject:** Work Space In The Home Costs

During the current year, Jobul Krist has the following costs:

| | |
|---|---|
| Utilities | $2,400 |
| Maintenance And Repairs | 4,600 |
| Property Taxes | 5,200 |
| House Insurance | 2,300 |
| Interest On Mortgage | 7,800 |
| Repainting And Rewiring The Work Space In The Home | 1,000 |
| Home Internet Service Fees | 960 |

| | |
|---|---|
| Home Telephone: | |
| Monthly Charge | 600 |
| Employment/Business Related Long Distance Charges | 390 |

Mr. Krist is a workaholic with no family, friends, pets or personal interests. He estimates that he uses 25 percent of his residence and 95 percent of his home phone and home internet service for employment/business related purposes. Maximum CCA on 100 percent of the house would be $12,000. Determine the maximum deduction that would be available to Mr. Krist assuming:

A. He is an employee with $250,000 in income (no commissions).
B. He is an employee with $250,000 in commission income.
C. He is self-employed and earns $250,000 in business income.

**SOLUTION available in print and online Study Guide.**

**We suggest you work Self Study Problem Six-3 at this point.**

### Foreign Media Advertising - ITA 19 And 19.1

6-101. In order to provide some protection to Canadian media, the *Income Tax Act* places limitations on the deductibility of advertising expenditures in foreign media. For print media, this limitation is found in ITA 19, with ITA 19.1 containing a corresponding provision for broadcast media. In general, these provisions deny a deduction for expenditures made in foreign print or foreign broadcast media in those cases where the advertising message is directed primarily at the Canadian market. It does not apply where such foreign media expenditures are focused on non-Canadian markets.

6-102. ITA 19.01 modifies the general non-deductibility rule by exempting certain foreign periodicals. Canadian businesses can deduct 100 percent of advertising costs in these publications, without regard to whether it is directed at the Canadian market, provided 80 percent or more of its non-advertising content is "original editorial content". Original editorial content is defined as non-advertising content:

- the author of which is a Canadian citizen or a permanent resident of Canada and, for this purpose, "author" includes a writer, a journalist, an illustrator and a photographer; or
- that is created for the Canadian market and has not been published in any other edition of that issue of the periodical published outside Canada.

6-103. If the periodical cannot meet the 80 percent criteria, only 50 percent of such advertising costs will be deductible. Note that ITA 19.01 applies to periodicals only, and not to other foreign media.

## Limitations On Deductions From Business, Property, And Employment Income

### Introduction

6-104. The restrictions that are found in ITA 18 through ITA 19.1 are applicable only to business and property income. For the most part, they involve expenses that would only be deductible against this type of income and so the restriction has no influence on the determination of other types of income. The exception to this is work space in the home costs, which can be deducted in the calculation of either employment or business income. Note, however, that in this case, different ITA Sections are applicable to each type of income.

6-105. Other types of expenses, for example business meals and entertainment, can be deducted against either employment or business income. The restrictions on deductions of these more general types of expenses are applicable to business, property, or employment income and, as a consequence, they are found in other Sections of the *Act*. More specifically, Division B's Subdivision f, "Deductions In Computing Income", covers these restrictions.

## Reasonableness

6-106. Subdivision f begins with a broad, general rule which limits deductible expenses to those that are "reasonable in the circumstances". This general limitation, which is applicable to the determination of business, property, or employment income, is as follows:

> **ITA 67** In computing income, no deduction shall be made in respect of an outlay or expense in respect of which any amount is otherwise deductible under this Act, except to the extent that the outlay or expense was reasonable in the circumstances.

6-107. This general rule is most commonly applied in non-arm's length situations. For example, it is fairly common for the sole owner of a small private company to make salary payments to a spouse and/or children. While there is a considerable amount of latitude for the amount of such payments, the owner should be able to demonstrate that the individual who received the payment provided services that had a value that could reasonably be associated with the amount received.

> **EXAMPLE** The sole shareholder of a private corporation appoints his 6 month old daughter as vice president of the corporation and pays her a salary of $100,000. (While this sounds absurd, similar arrangements have been attempted.)

> **ANALYSIS** As the services of a 6 month old are extremely unlikely to have any business value, the $100,000 would be disallowed on the grounds of being unreasonable in the circumstances.

## Meals And Entertainment

### *General Rules - ITA 67.1*

6-108. It can be argued that business expenditures for food, beverages, or entertainment involve an element of personal living costs and, to the extent that this is true, such amounts should not be deductible in calculating Net Income For Tax Purposes. This idea is embodied in ITA 67.1(1) which restricts the amount that can be deducted for the human consumption of food or beverages, or the enjoyment of entertainment. The amount of these costs that can be deducted is equal to 50 percent of the lesser of actual costs and an amount that would be considered reasonable in the circumstances. The Subsection makes it clear that this limit does not apply to meals related to moving costs, child care costs, amounts eligible for the medical expense tax credit or amounts eligible for the adoption expenses tax credit. Further exceptions to this general rule are described in the next section of this Chapter.

### *Exceptions*

6-109. ITA 67.1(1.1) provides an exception to the 50 percent for meal costs incurred by long-haul truck drivers during eligible travel periods (i.e., away from home for at least 24 continuous hours). Individuals who are long-haul truck drivers and their employers can deduct 80 percent of the cost of eligible meals.

6-110. ITA 67.1(2) provides a number of additional exceptions for food and entertainment. Situations where the 50 percent rule does not apply include:

- Hotels, restaurants, and airlines provide food, beverages, and entertainment in return for compensation from their customers. The costs incurred by these organizations in providing these goods and services continue to be deductible. However, when the employees of these organizations travel or entertain clients, their costs are subject to the 50 percent limitation.
- Meals and entertainment expenses relating to a fund raising event for a registered charity are fully deductible.
- Where the taxpayer is compensated by someone else for the cost of food, beverages, or entertainment and the amount is separately identified in writing. Such amounts will be fully deductible against this compensation. For example, if Mr. Spinner was a management consultant and was reimbursed by his client for separately billed meals

and entertainment, he could deduct 100 percent of these costs. However, his client would only be able to deduct 50 percent of the reimbursements.

- When amounts are paid for meals or entertainment for employees and, either the payments create a taxable benefit for the employee, or the amounts do not create a taxable benefit because they are being provided at a remote work location, the amounts are fully deductible to the employer.
- When amounts are incurred by an employer for food, beverages, or entertainment at a special event that is generally available to all individuals employed by the taxpayer, the amounts are fully deductible. Note, however, this exception applies to no more than six special events held by an employer during a calendar year.

6-111. In addition to the preceding exceptions, ITA 67.1(3) provides a special rule for meals that are included in conference or convention fees. When the amount included in the fee for meals and entertainment is not specified, the Subsection deems the amount to be $50 per day. In these circumstances, it is this $50 per day that is subject to the 50 percent limitation.

6-112. Airline, bus, and rail tickets can include meals in their price. It appears that the government views the value of such meals as being fairly immaterial (those of you who have consumed airline food would likely agree with this conclusion on the value of such meals). This is reflected in the fact that ITA 67.1(4) deems the food component of the ticket cost to be nil.

## "Luxury" Automobile Costs

6-113. When a business provides an automobile to an employee or shareholder, it is clear that these individuals have received a taxable benefit to the extent that they make any personal use of the vehicle. This fact, along with the methods used to calculate the benefit, was covered in detail in Chapter 3. As you will recall, the amount of the benefit is based on the cost of cars purchased or, alternatively, the lease payments made on cars that are leased.

6-114. A different issue relates to the costs that can be deducted by a business in the determination of its net business income, or by any employee in the determination of net employment income. For many years, it has been the policy of the government to discourage the deduction of costs related to the use of what is perceived to be luxury automobiles. This has been accomplished by limiting the amounts that can be deducted for:

- CCA on cars owned by the taxpayer;
- interest costs on cars owned by the taxpayer and financed with debt; and
- lease payments on cars that are leased by the taxpayer.

6-115. Before describing these limitations, we would again remind you that the taxable benefit that results from a business providing an automobile to an employee or shareholder is calculated without regard to restrictions on the deductibility of its costs. For example, if an employee has the exclusive personal use of a passenger vehicle that has been acquired by his employer for $150,000, his basic standby charge for each year would be $36,000 [(2%)(12)($150,000)]. The calculation of this amount will not be affected by the fact that the employer's deduction for CCA on this automobile is based on only $30,000.

## Automobiles Owned By The Taxpayer

### *Limits On CCA - ITA 13(7)(g)*

6-116. With respect to cars that are owned by a business, ITA 13(7)(g) limits the deductibility of capital costs to a prescribed amount. From 2001 through 2019, this prescribed amount has been unchanged at $30,000, plus GST/HST and PST. This amount would be reduced by any GST/HST and PST that was recoverable as input tax credits.

### *Limits On Interest - ITA 67.2*

6-117. When the automobile is owned by the business, there may be interest costs associated with related financing. If this is the case, ITA 67.2 restricts the amount of interest that can be deducted to an amount determined by the following formula:

$$(A \div 30)(B), \text{ where}$$

**A** is a prescribed amount ($300 from 2001 through 2019)
**B** is the number of days in the period during which interest is paid or payable

6-118. While the popular press sometimes describes this limit as $300 per month, you can see from the formula that this is not correct. For 2019, the correct limit is $10 per day.

## Exercise Six - 8

**Subject:** Deductible Automobile Costs (Business Owns Automobile)

On October 1, 2019, Ms. Vanessa Lord purchased an automobile to be used exclusively in her newly formed unincorporated business that commenced operations on September 15, 2019. The cost of the automobile was $45,000, before GST and PST. She finances a part of the purchase price and, as a consequence, has financing charges for the period October 1 to December 31, 2019 of $1,200. In calculating her net business income for 2019, how much can Ms. Lord deduct with respect to this acquisition? Ignore GST and PST considerations.

**SOLUTION available in print and online Study Guide.**

## Automobile Leasing Costs - ITA 67.3

### *Basic Formula (Cumulative)*

6-119. When a business leases a passenger vehicle, ITA 67.3 restricts the deductibility of the lease payments to a prescribed amount. The basic formula that is used to implement this limitation is as follows:

$$\text{Basic Cumulative Formula} = \left[A \text{ X } \frac{B}{30}\right] - C - D - E, \text{ where}$$

**A** is a prescribed amount ($800 for vehicles leased in 2001 through 2019);
**B** is the number of days from the beginning of the term of the lease to the end of the taxation year (or end of the lease if that occurs during the current year);
**C** is the total of all amounts deducted in previous years for leasing the vehicle;
**D** is a notional amount of interest since the inception of the lease, calculated at the prescribed rate on refundable amounts paid by the lessee in excess of $1,000;
**E** is the total of all reimbursements that became receivable before the end of the year by the taxpayer in respect of the lease.

6-120. In simplified language, this Section restricts, for leases entered into in the years 2001 through 2019, the deductibility of lease payments to $800 (Item A) plus GST/HST and PST, for each 30 day period from the inception of the lease through the end of the current taxation year. Note that this is a cumulative amount over the entire lease term and this means that the prescribed amount for the year in which the lease is signed is applicable throughout the lease term. That is, if the $800 limit was increased after 2019, the change would have no effect on the leasing cost limit calculations for leases entered into in 2019.

6-121. The formula also contains components that:

- remove lease payments that were deducted in previous taxation years (Item C);
- require the deduction of imputed interest on refundable deposits that could be used by the lessee to reduce the basic lease payments (Item D);
- remove reimbursements that are receivable by the taxpayer during the year (Item E).

6-122. In applying this formula, it is important to note that all of the components are cumulative from the inception of the lease.

### *Anti-Avoidance Formula*

6-123. While the basic concept of limiting the deductible amount to a prescribed figure is fairly straightforward, it would be very easy to avoid the intended purpose of the preceding formula. Almost any vehicle can be leased for less than $800 per 30 day period through such measures as extending the lease term, or including a required purchase by the lessee at the end of the lease term at an inflated value. Because of this, a second formula is required and is based on the manufacturer's suggested list price for the vehicle and is as follows:

$$\text{Anti – Avoidance Formula} = \left[A \text{ X } \frac{B}{.85\text{ C}}\right] - D - E\text{, where}$$

**A** is the total of the actual lease charges paid or payable in the year;
**B** is a prescribed amount ($30,000 for vehicles leased in 2001 through 2019);
**C** is the greater of a prescribed amount ($35,294 for vehicles leased in 2001 through 2019) and the manufacturer's list price for the vehicle (note that this is the original value, even when a used vehicle is leased);
**D** is a notional amount of interest for the current year, calculated at the prescribed rate on refundable amounts paid by the lessee in excess of $1,000;
**E** is the total of all reimbursements that became receivable during the year by the taxpayer in respect of the lease.

6-124. Note that, unlike the calculations in the basic cumulative formula, the components of this formula are for the current year only. Also note that the .85 in the denominator is based on the assumption of a standard 15 percent discount off the manufacturers' list price. When the list price is $35,294, 85 percent of this amount is $30,000, leaving the (B ÷ .85C) component equal to one. This means that this component only kicks in when the list price exceeds $35,294, a vehicle that the formula assumes has been acquired for $30,000.

### *Deductible Amount*

6-125. ITA 67.3 indicates that, when lease payments are being deducted, the amount cannot exceed the actual amount paid and the lesser of the two formula based amounts. This means that the deductible amount is the least of:

- the actual amount of the lease payments;
- the amount determined using the basic cumulative formula; and
- the amount determined using the anti-avoidance formula.

### *Example*

6-126. The following example will serve to illustrate the application of these rules.

**EXAMPLE** A car with a manufacturer's list price of $60,000 is leased on December 1, 2018 by a company for $1,612 per month, payable on the first day of each month. The term of the lease is 24 months and a refundable deposit of $10,000 is made at the inception of the lease. In addition, the employee who drives the car pays the company $200 per month for personal use. Assume that the prescribed rate is 2 percent per annum for all periods under consideration. Ignoring GST and PST implications, determine the maximum deductible lease payments for 2018 and 2019.

**ANALYSIS - 2018** For 2018, the D component in both of the ITA 67.3 formulae is $15 [(2%)($10,000 - $1,000)(31/365)]. The E component is $200 [($200)(1)]. The maximum deduction for 2018 is $612, the least of the following amounts:

- $[(\$1,612)(1)] = \underline{\underline{\$1,612}}$
- $\left[\$800 \times \frac{31}{30}\right] - \$0 - \$15 - \$200 = \underline{\underline{\$612}}$ (Basic cumulative formula)
- $\left[\$1,612 \times \frac{\$30,000}{(85\%)(\$60,000)}\right] - \$15 - \$200 = \underline{\underline{\$733}}$ (Anti-avoidance formula)

**ANALYSIS - 2019** Because the lease was entered into during 2018, the 2018 limit of \$800 applies for the life of the lease. For 2019, the D components in the ITA 67.3 formula are \$195 [(2%)(\$10,000 - \$1,000)(396/365)] in the basic formula and \$180 [(2%)(\$10,000 - \$1,000)(365/365)] in the anti-avoidance formula.

The 2019 E components are \$2,600 [(\$200)(13)] in the basic formula, and \$2,400 [(\$200)(12)] in the anti-avoidance formula.

The maximum deduction for 2019 is \$7,153, the least of the following amounts:

- [(\$1,612)(12)] = $\underline{\underline{\$19,344}}$
- $\left[\$800 \times \frac{396}{30}\right] - \$612 - \$195 - \$2,600 = \underline{\underline{\$7,153}}$ (Basic cumulative formula)
- $\left[\$19,344 \times \frac{\$30,000}{(85\%)(\$60,000)}\right] - \$180 - \$2,400 = \underline{\underline{\$8,799}}$ (Anti-avoidance formula)

## Exercise Six - 9

**Subject:** Deductible Automobile Costs (Business Leases Automobile)

On August 1, 2019, Mr. Sadim Humiz leases an automobile to be used 100 percent of the time in his unincorporated business. The lease cost is \$985 per month. The manufacturer's suggested list price for the automobile is \$78,000. Mr. Humiz makes no down payment and no refundable deposits. Determine his maximum deduction for lease payments for 2019. Ignore GST and PST considerations.

**SOLUTION available in print and online Study Guide.**

**We suggest you work Self Study Problems Six-4, 5 and 6 at this point.**

## Leasing Property

6-127. While, from a legal perspective, leasing a property is a distinctly different transaction than purchasing the same property, the economic substance of many long-term leases is that they are arrangements to finance the acquisition of assets. This fact has long been recognized by accounting standard setters, both in Canada and internationally. Accounting standards for leases require that, when a leasing arrangement transfers the usual risks and rewards of ownership to a lessee, the lease must be treated as a sale by the lessor and a purchase by the lessee.

6-128. In general, this view is not recognized by the CRA. For tax purposes, a lease is always treated as a lease. The actual lease payments will be included in the income of the lessor and deducted from the income of the lessee. However, there is a provision under ITA 16.1 which allows the lessee and lessor to elect to treat the lease in the same manner that it is treated under accounting rules.

6-129. Unless ITA 16.1 is used, there can be significant difference between the accounting and tax rules for dealing with leases. For accounting purposes, when a lease transfers the usual risks and rewards of ownership, the lessee will record an asset and an obligation, while the lessor will record either a sale of an asset or a lease receivable. The expenses and revenues related to this approach will usually be significantly different from the lease payments and receipts recorded for tax purposes.

## Exercise Six - 10

**Subject:** Leases: Tax vs. GAAP Treatment

Markit Ltd. signs a 10 year lease for an asset with an economic life of 11 years. The lease payments are $23,000 per year. Compare the tax treatment of the lease with its treatment under GAAP.

**SOLUTION available in print and online Study Guide.**

## Illegal Payments, Fines And Penalties - ITA 67.5 And 67.6

6-130. Under ITA 67.5, "Non-Deductibility Of Illegal Payments", payments made to Canadian or foreign government officials that constitute an offence under certain provisions of either the *Corruption of Public Foreign Officials Act* or Canada's *Criminal Code* are not deductible. This would be the case, even if the related income was taxable.

6-131. It is not uncommon for fines and penalties to be incurred in the process of carrying on business activity (e.g., the driver for a courier company receives a parking ticket while making a delivery). ITA 67.6, "Non-Deductibility Of Fines And Penalties" states that no deduction can be made for any fine or penalty imposed under a law of a country or of a political subdivision of a country.

6-132. You can find a more detailed discussion of the issues related to fines and penalties in IT Folio S4-F2-C1, *Deductibility Of Fines And Penalties*.

# Business Income - Specific Deductions

## Inventory Valuation (Cost Of Sales)

### *General Procedures*

6-133. IT-473R points out that ITA 10 and ITR 1801 allow two alternative methods of inventory valuation. They are:

- valuation at lower of cost or fair market value for each item (or class of items if specific items are not readily distinguishable) in the inventory;
- valuation of the entire inventory at fair market value.

6-134. The selected method must be applied consistently from year to year, and cannot normally be changed. IT-473R indicates that, in exceptional circumstances, the CRA will allow a change, provided it can be shown that the new method is more appropriate, it is used consistently in future periods, and the new method is used for financial statement purposes.

6-135. IT-473R indicates that fair market value can mean either replacement cost or net realizable value. The Bulletin also notes that the method used in determining "fair market value" for income tax purposes should normally be the same as the method used to determine "market" for financial statement purposes.

6-136. IT-473R indicates that cost can be determined through specific identification, an average cost assumption, a First In, First Out (FIFO) assumption, or through the use of the retail method. However, the Bulletin specifically prohibits the use of a Last In, First Out (LIFO) assumption for the determination of inventory costs. Since GAAP does not allow LIFO for accounting purposes, it cannot be used for either tax or accounting purposes.

### *Overhead Absorption*

6-137. While not discussed in ITA 10, IT-473R indicates that, in the case of the work in process and finished goods inventories of manufacturing enterprises, an applicable share of overhead should be included. The CRA will accept either direct costing, in which only variable overhead is allocated to inventories, or absorption costing, in which both variable and fixed overhead is added to inventories. The Bulletin does indicate, however, that the method used should be the one that gives the truer picture of the taxpayer's income.

6-138. Under absorption costing, amortization will generally be a component of the overhead included in beginning and ending inventories. In calculating net business income, the amounts recorded as accounting amortization will be replaced by amounts available as CCA deductions. This process will require adjustments reflecting any amounts of amortization included in beginning and ending inventories. While these adjustments go beyond the scope of this text, interested readers will find that they are illustrated in an Appendix to IT-473R.

### Tax Vs. GAAP

6-139. GAAP rules for inventories (both the *International Financial Reporting Standard* and the *Accounting Standard For Private Enterprises*) can be compared to tax rules as follows:

**Inventory Valuation** For tax purposes, inventories can be valued at either lower of cost and fair market value, or at fair market value. The accounting rules require that inventories be valued at the lower of cost and net realizable value.

**Determination Of Market** For tax purposes, market can be determined using either replacement cost or net realizable value. The accounting rules require the use of net realizable value.

**Determination Of Cost** For tax purposes, cost can be determined using specific identification, a First In, First Out (FIFO) or average cost assumption, or through the use of the retail method. The accounting rules permit the use of the same methods, but is more prescriptive with respect to when each method must be used.

**Use Of Direct Costing** The use of direct costing is not permitted for accounting purposes. We have noted that, with respect to this issue, IT-473R does permit the use of direct costing provided it is the method that gives a "truer picture" of the taxpayer's income. However, with the accounting rules prohibiting the use of direct costing, it would be difficult to argue that this method provides such a picture.

6-140. While there are some differences between the tax rules and the accounting requirements, the two sets of rules are largely the same. Differences can arise, however, in situations where depreciation (CCA) is included in the determination of inventory values.

### Special Rule For Artists

6-141. When artists are required to apply normal inventory valuation procedures, it prevents them from writing off the cost of their various works until they are sold. Given the periods of time that such works are sometimes available for sale, this can result in hardship for some artists. As a consequence, ITA 10(6) allows artists to value their ending inventories at nil, thereby writing off the costs of producing a work prior to its actual sale.

## Exercise Six - 11

**Subject:** Inventory Valuation

Brandon Works sells a single product which it buys from various manufacturers. It has a December 31 year end. During 2019, purchases of this item were as follows:

| Date | Quantity | Price |
|---|---:|---:|
| February 1 | 50,000 | $2.50 |
| May 23 | 35,000 | 2.85 |
| August 18 | 62,000 | 2.95 |
| October 28 | 84,000 | 3.05 |

On December 31, 2019, 102,000 of these items are on hand. Their replacement cost on this date is $3.10 and they are being sold for $4.50. It is estimated that selling costs average 10 percent of the sales price. It is not possible to identify the individual items being sold. Calculate all the values that could be used for the 102,000 remaining units for tax purposes, identifying the method you used for each value.

**SOLUTION available in print and online Study Guide.**

**We suggest you work Self Study Problem Six-7 at this point.**

## Other Deductions

6-142. Earlier in this Chapter we described some of the many restrictions that the *Income Tax Act* places on the deduction of items in the determination of net business income. In considering these restrictions, it becomes clear that they also serve to provide general guidance on the items that are deductible.

6-143. In addition to this general guidance, ITA 20 contains a detailed list of specific items that can be deducted in computing net business income. If an item falls clearly into one of ITA 20's deduction categories, it is not subject to the restrictions listed in ITA 18. Some of the more important deductions described in ITA 20 are as follows:

- 20(1)(a) - **Capital Cost Of Property** This Paragraph provides for the deduction of a portion of the cost of capital assets as capital cost allowances. The detailed provisions related to this deduction are covered in Chapter 5.
- 20(1)(b) - **Incorporation Expenses** This paragraph provides for the deduction of up to $3,000 in incorporation expenses. Incorporation expenses in excess of this amount are added to Class 14.1.
- 20(1)(c) and (d) - **Interest** These two Paragraphs cover both current and accrued interest, provided the borrowed money was used to earn business or property income. Chapter 7 contains a detailed discussion of some of the problems that arise in this area.
- 20(1)(e) - **Expenses Re Financing** In general, costs related to the issuance of shares or incurred on the borrowing of funds must be deducted on a straight-line basis over five years. Any undeducted financing costs can be written off if the loan is repaid or the shares redeemed prior to the end of five years.
- 20(1)(f) - **Discount On Certain Obligations** For tax purposes, bond discount cannot be amortized over the life of the bonds, the normal accounting treatment. This means that only the amount of interest actually paid can be deducted in the determination of business income. It also means that, since the discount balance is not being amortized, it will have to be deducted when the bonds are retired. If the bonds are issued for not less than 97 percent of their maturity amount and, if the effective yield is not more than 4/3 of the coupon rate, the full amount of the discount can be deducted when the bonds are retired. If these conditions are not met, the payment of the discount at maturity is treated in the same manner as a capital loss, with only one-half of the payment being deductible.
- Note that the tax treatment of bond premiums also differs from the normal accounting treatment. We would note here that, for tax purposes, bond premiums will not normally be amortized over the life of the bond. This issue is discussed in more detail in Chapter 7 which deals with property income.
- 20(1)(j) - **Repayment Of Loan By Shareholder** As is explained in Chapter 15, if a loan to a shareholder is carried on the Balance Sheet of a corporation for two consecutive year ends, the principal amount must be added to the income of the borrower. This Paragraph provides for a deduction when such loans are repaid.
- 20(1)(l) - **Reserves For Doubtful Debts** See Paragraphs 6-58 to 6-61.
- 20(1)(m) - **Reserves For Goods And Services To Be Delivered In Future Taxation Years** See Paragraph 6-62.
- 20(1)(m.1) - **Reserves For Warranties** This provision only applies to amounts paid to third parties to provide warranty services. It does not apply to so-called "self warranty" situations where the business that sold the warrantied item assumes the risk of providing warranty services.

- 20(1)(n) - **Reserve For Unpaid Amounts** This reserve provides for limited use of cash based revenue recognition in computing net business income. See Paragraph 6-63.
- 20(1)(p) - **Actual Write Offs Of Bad Debts** See Paragraphs 6-58 to 6-61.
- 20(1)(q) - **Employer's Contributions To Registered Pension Plans** This deduction is subject to the limitations described in Chapter 10. At this point we would note that, unlike the accrual approach to pension costs that is used for financial reporting purposes, this deduction is on a cash basis. For tax purposes, the deduction for pension costs is based entirely on funding payments made during the year or within 120 days after the end of the year.
- 20(1)(y) - **Employer's Contributions Under A Deferred Profit Sharing Plan** Only amounts that are paid during the year or within 120 days of the end of the year can be deducted.
- 20(1)(z) and (z.1) - **Costs Of Cancellation Of A Lease** This deduction, in effect, requires amounts paid by a lessor to cancel a lease to be treated as a prepaid expense. Such amounts can be deducted on a pro rata per diem basis over the remaining term of the lease, including all renewal periods. If the property is sold subsequent to the cancellation, the remaining balance can be deducted at that time. If the property is a capital property, only one-half of the remaining balance can be deducted.
- 20(1)(aa) - **Costs For Landscaping Of Grounds** In the absence of this provision, landscaping costs would have to be treated as a capital expenditure. While this provision allows for an immediate deduction, it is based on amounts paid in the year. Costs accrued at the end of the taxation year cannot be deducted.
- 20(1)(cc) - **Expenses Of Representation**
- 20(1)(dd) - **Costs Of Investigation Of A Site To Be Used In The Business**
- 20(1)(oo) - **Amounts Deferred Under A Salary Deferral Arrangement**
- 20(1)(qq) and (rr) - **Disability Related Costs** These two paragraphs allow the costs of disability related building modifications and acquisitions of disability related equipment to be treated as current deductions, rather than as capital assets. Like the similar provision for landscaping costs, the deduction is only available for amounts paid during the year.
- 20(4) - **Uncollectible Proceeds From Disposition Of A Depreciable Property**
- 20(10) - **Convention Expenses** This allows the taxpayer to deduct the costs of attending no more than two conventions held during the year, provided they are in a location that is consistent with the territorial scope of the organization.
- 20(11) - **Foreign Taxes On Income From Property Exceeding 15 Percent** This provision is only applicable to individuals and reflects the fact that an individual's credit for foreign taxes paid is limited to 15 percent. This matter is discussed in Chapters 7 and 11.
- 20(16) - **Terminal Losses** This deduction was explained in Chapter 5.

# Reconciliation Schedule

6-144. While it would be possible to calculate net business income starting with a blank page, adding inclusions, and subtracting deductions, this approach is rarely used. Since most businesses have an accounting system that produces an accounting Net Income figure, the normal approach to determining net business income is to start with accounting Net Income, then add and deduct various items that are different for tax purposes. Note, however, that some smaller businesses that do not require audited financial statements base their regular accounting system on tax rules. In such cases, no reconciliation is needed.

**Figure 6 - 3**
**Conversion Of Accounting Net Income To Net Income For Tax Purposes**

**Additions To Accounting Income:**
- Income tax expense
- Amortization, depreciation, and depletion of tangible and intangible assets (accounting amounts)
- Recapture of CCA
- Tax reserves deducted in the prior year
- Losses on the disposition of capital assets (accounting amounts)
- Pension expense (accounting amounts)
- Scientific research expenditures (accounting amounts)
- Warranty expense (accounting amounts)
- Amortization of discount on long-term debt issued (see discussion in Chapter 7)
- Foreign tax paid (accounting amounts)
- Excess of taxable capital gains over allowable capital losses
- Interest and penalties on income tax assessments
- Non-deductible automobile costs
- 50 percent of business meals and entertainment expenses
- Club dues and cost of recreational facilities
- Non-deductible reserves (accounting amounts)
- Charitable donations
- Asset write-downs including impairment losses on intangibles
- Fines, penalties, and illegal payments

**Deductions From Accounting Income:**
- Capital cost allowances (CCA)
- Incorporation costs (First $3,000)
- Terminal losses
- Tax reserves claimed for the current year
- Gains on the disposition of capital assets (accounting amounts)
- Pension funding contributions
- Deductible scientific research expenditures
- Deductible warranty expenditures
- Amortization of premium on long-term debt issued
- Foreign non-business tax deduction [ITA 20 (12)]
- Allowable business investment losses
- Landscaping costs

6-145. For those businesses that base their accounting system in whole or part on GAAP, a reconciliation between accounting Net Income and net business income is required. While there are many other items that could require adjustment, the items shown in Figure 6-3 are the common reconciliation items for most taxpayers.

6-146. In working with this schedule, several general points are relevant:

- Accounting Net Income is an after tax concept. This means that the Tax Expense that is recorded in the accounting records must be added back in this reconciliation schedule. This addition would include both the current tax expense and any future tax expense or benefit recorded under GAAP.
- The amounts deducted in the accounting records for amortization, scientific research, and resource amounts will generally be different from the amounts deducted for tax purposes. While it would be possible to simply deduct the net difference (the tax amount is normally larger than the accounting amount), the traditional practice here is to add back the accounting amount and subtract the tax amount (e.g., we add back accounting amortization and subtract CCA).
- Accounting gains on the disposition of capital assets will be deducted and losses added in this schedule. With these amounts removed, they will be replaced by the relevant tax amounts. As explained in Chapter 5, the disposition of depreciable

capital assets can result in capital gains, recapture, or terminal losses. In addition, capital losses can arise on the disposition of non-depreciable capital assets. These amounts are listed separately in Figure 6-3.

- As was noted in Chapter 1, allowable capital losses can only be deducted against taxable capital gains. As a consequence, only the excess of taxable capital gains over allowable capital losses is included in this schedule. If there is an excess of allowable capital losses over taxable capital gains in the current year, the excess can be carried forward or carried back, but it cannot be deducted in the current year. As a consequence, such amounts are not included in this reconciliation schedule.
- You will note that there are no adjustments related to either Sales or Cost Of Sales. With respect to sales, this simply reflects the fact that the tax and accounting rules produce, in the great majority of situations, identical results. With respect to Cost Of Sales, differences between the *Income Tax Act* and GAAP are not common and were covered in Paragraph 6-139.

# Business Income - Example

## Example Data

6-147. The Markee Company has a December 31 accounting and taxation year end and, for the year ending December 31, 2019, its GAAP determined income before taxes amounted to $1,263,000. You have been asked to calculate the Company's 2019 Net Income For Tax Purposes, and have been provided with the following additional information concerning the 2019 fiscal year:

1. Accounting amortization expense totalled $240,000. For tax purposes, the Company intends to deduct CCA of $280,000.
2. Accounting income includes a gain on the sale of land in the amount of $20,000. For tax purposes, one-half of this amount will be treated as a taxable capital gain.
3. During December, the Company spent $35,000 on landscaping costs. These costs were capitalized in the Company's accounting records. As the expenditure was near the end of the year, no amortization was recorded.
4. The Company's Interest Expense includes $5,000 in bond discount amortization.
5. Financing costs, incurred on January 1, to issue new common stock during the year totaled $60,000. All of these costs were charged to expense in the accounting records.
6. Accounting expenses include $48,000 in business meals and entertainment.
7. During the year, the Company begins selling a product on which it provides a five year warranty. At the end of the year, it recognizes a warranty liability of $20,000.
8. In the accounting records, the Company recognized a Pension Expense of $167,000. Contributions to the pension fund totaled $150,000.
9. The Company leased a car beginning on June 1, 2018 that is used by the sales manager. The lease payments are $750 per month on a car with a manufacturer's suggested list price of $33,000. No refundable deposit was paid.

## Example Analysis

6-148. The following points are relevant to the Net Income calculation:

- Item 1 - The accounting amortization has to be added back and replaced with the CCA deduction.
- Item 2 - The accounting gain has to be removed and replaced by the taxable capital gain.

- Item 3 - Despite the fact that landscaping costs are usually capital costs, ITA 20(1)(aa) specifically permits their immediate deduction.
- Item 4 - The bond discount has to be added back to income.
- Item 5 - Financing costs must be amortized over five years on a straight-line basis under ITA 20(1)(e). As a result, only $12,000 is deductible in the current year and $48,000 must be added back to income.
- Item 6 - Only 50 percent of business meals and entertainment can be deducted.
- Item 7 - Warranty costs can only be deducted as incurred.
- Item 8 - Pension costs can only be deducted when they are funded.
- Item 9 - The lease payments are not limited by the restrictions described beginning in Paragraph 6-119. As a result, the payments are fully deductible and no adjustment is needed.

6-149. Based on the preceding analysis, the calculation of 2019 Net Income For Tax Purposes would be as follows:

| | | |
|---|---|---|
| Accounting Income Before Taxes | | $1,263,000 |
| Additions (Identified By Item Number): | | |
| 1 - Accounting amortization | $240,000 | |
| 2 - Taxable capital gain on land sale [(1/2)($20,000)] | 10,000 | |
| 4 - Bond discount amortization | 5,000 | |
| 5 - Financing costs [(80%)($60,000)] | 48,000 | |
| 6 - Meals and entertainment [(50%)($48,000)] | 24,000 | |
| 7 - Warranty liability | 20,000 | |
| 8 - Unfunded pension expense ($167,000 - $150,000) | 17,000 | 364,000 |
| Deductions (Identified By Item Number): | | |
| 1 - Capital Cost Allowance (CCA) | ($280,000) | |
| 2 - Accounting gain on sale of land | ( 20,000) | |
| 3 - Landscaping costs | ( 35,000) | ( 335,000) |
| Net Income For Tax Purposes | | $1,292,000 |

**We suggest you work Self Study Problems Six-8, 9, and 10 at this point.**

# Taxation Year

## General Rules

6-150. The *Act* defines a taxation year as follows:

**ITA 249(1)** For the purpose of this Act, a "taxation year" is

(a) in the case of a corporation, a fiscal period, and

(b) in the case of an individual, a calendar year,

and when a taxation year is referred to by reference to a calendar year, the reference is to the taxation year or years coinciding with, or ending in, that year.

6-151. For corporations, ITA 249.1(1) defines a fiscal period as a period that does not exceed 53 weeks. The 53 week designation provides for situations where a corporation wishes to have a fiscal period that ends in a specified week within a month. For example, if the corporate year end is the last Friday in January, the fiscal year will, in some years, include 53 weeks.

6-152. A new corporation can select any fiscal year end. However, subsequent changes require the approval of the Minister, unless a specific provision provides for a change (e.g., an amalgamation or acquisition of control). In most situations, corporations will have a fiscal year for tax purposes that coincides with the fiscal period used in their financial statements.

## Unincorporated Businesses - Non-Calendar Fiscal Year

6-153. Unincorporated businesses such as proprietorships and partnerships are not, for income tax purposes, separate taxable entities. The income of such businesses is included in the tax return of the individual proprietor or partner.

6-154. While unincorporated businesses are not required to file an income tax return, they are required to calculate an annual business income figure to be included in the tax returns of their owners. Given that the individuals who are the owners of proprietorships and partnerships must use a taxation year based on the calendar year, it would seem logical to require that these unincorporated businesses also base their taxation year on a calendar year.

6-155. This logic is overridden, however, by the fact that there can be important reasons, unrelated to income tax, for the use of a non-calendar fiscal year (e.g., having the year end at a low point in the activity of the business). As a consequence, under ITA 249.1(4), a proprietorship or partnership can elect to have a fiscal year that does not end on December 31.

6-156. This election is available to any new unincorporated business. However, it must be made on or before the filing date for the individual proprietor or partner. This would be June 15 of the year following the year in which the business commences. The election cannot be made in a subsequent year.

6-157. If the election is made, ITA 34.1(1) requires taxpayers to include an amount of income for the period between the end of their normal fiscal year and December 31 of that year. This income is referred to as "additional business income" and, in simple terms, it is a pro rata extrapolation of the income earned during the non-calendar fiscal period that ends in the year. It is used to create an estimate of the income that will be earned from the end of the non-calendar fiscal period to the end of the calendar year. A simple example will illustrate this process.

> **EXAMPLE** Jack Bartowski forms a new business on November 1, 2018. Because of the cyclical nature of his business, he chooses a January 31 year end as it is a slow time in the business. Between November 1, 2018 and January 31, 2019, he has net business income of $25,000. During the fiscal year ending January 31, 2020, the net business income is $80,000.
>
> **ANALYSIS - 2019** The period November 1, 2018 through January 31, 2019 has 92 days. The period from February 1, 2019 to December 31, 2019 has 334 days. Based on this, the "additional business income" that must be added for 2019 is calculated as follows:
>
> [($25,000)(334 Days ÷ 92 Days)] = $90,761
>
> The income that will be reported by Mr. Bartowski in his 2019 personal tax return is calculated as follows:

| | |
|---|---|
| Actual Business Income: | |
| November 1, 2018 To January 31, 2019 | $ 25,000 |
| Additional Business Income: | |
| February 1, 2019 To December 31, 2019 (Estimate) | 90,761 |
| 2019 Business Income | $115,761 |

> Note that he will be taxed on his estimated income for 14 months. If reporting for this 14 month period would push him into a different tax bracket for 2019, there is an election available that would alleviate this situation by allowing him to report the November and December 2018 income in 2018, and not 2019.

**ANALYSIS - 2020** The "additional business income" that must be added for 2020 is calculated as follows:

$$[(\$80,000)(334 \text{ Days} \div 365 \text{ Days})] = \underline{\underline{\$73,205}}$$

The 2020 business income will be calculated by taking the actual figure for February 1, 2019 through January 31, 2020, deducting the additional business income that was included in his 2019 tax return, and adding the new additional business income for the period February 1, 2020 through December 31, 2020. The calculations are as follows:

| | |
|---|---|
| Actual Business Income - February 1, 2019 To January 31, 2020 | $80,000 |
| Additional Business Income: | |
| Deduction Of Estimated Amount Added In 2019 | ( 90,761) |
| Addition Of Estimate Of Income for Feb. 1 to Dec. 31, 2020 | 73,205 |
| 2019 Business Income | $62,444 |

## Exercise Six - 12

**Subject:** Additional Business Income - Non-Calendar Fiscal Year

Mr. Morgan Gelato starts a business on March 1, 2019. Because it will be a slow time of year for him, he intends to have a fiscal year that ends on June 30. During the period March 1, 2019, through June 30, 2019, his business has income of $12,300. What amount of business income will Mr. Gelato report in his personal tax return for the year ending December 31, 2019?

**SOLUTION available in print and online Study Guide.**

**We suggest you work Self Study Problem Six-11 at this point.**

# Special Business Income Situations

## Income For Farmers

### *Farm Losses*

6-158. For an individual who looks to farming as his chief source of activity and income, farm losses are fully deductible against other types of income. The difficulty with farm losses is that there are various levels of interest in farming activity, ranging from a full time endeavour to produce profits from farming, through situations where an individual acquires a luxury home in a rural setting, allows three chickens to run loose in the backyard, and then tries to deduct all the costs of owning and operating the property as a "farm loss". In the latter case, the ownership of a "farm" is nothing more than a hobby or a means to enhance the individual's lifestyle.

6-159. For such hobby farmers, engaged in farming activity as merely an attractive addition to a lifestyle and with no serious intent to produce a profit from this type of activity, the costs of farming must be viewed as personal living expenses. This means that no portion of farm losses should be considered deductible by hobby farmers.

### *Restricted Farm Losses*

6-160. The more complex situation is an individual who expects to make a profit from farming but, in addition, has another source of income (e.g., a university professor who grows medicinal marijuana on a part time basis). In such situations, ITA 31 restricts the amount of farm losses that can be deducted.

6-161. This provision indicates that farm losses are subject to limits:

> "... if a taxpayer's chief source of income for a taxation year is neither farming nor a combination of farming and some other source of income that is a subordinate source of income for the taxpayer ..."

6-162. Stated alternatively, this provision states that in situations where an individual has both farming income and some other source of income, farm losses will be limited unless the other source of income is less important than the taxpayer's farming source.

6-163. As a result of this legislation, there are three classes of farmers.

- Hobby farmers with no expectation of profit. Such taxpayers cannot deduct any farm losses.
- Farmers whose major source of income is farming. Such taxpayers can deduct all of their losses against other sources of income; and
- Part-time farmers for whom farming income is a secondary source of income. Such farmers would have their losses "restricted" under ITA 31. Note that this category of farmers must have a reasonable expectation of profit.

6-164. For part-time farmers, the limit on the amount of current year farming losses that can be deducted against other current year sources of income is equal to the first $2,500 of such losses, plus one-half of the next $30,000, for a maximum deduction of $17,500 [$2,500 + (1/2) ($32,500 maximum - $2,500)] on farm losses of $32,500 or greater. Any amount of the farm loss that is not deductible in the current year is commonly referred to as a "restricted farm loss". Such amounts can be carried over to past or future years, but can only be deducted to the extent of farm income in the carry over years (see Chapter 11 for a more complete discussion of loss carry overs).

## Exercise Six - 13

**Subject:** Farm Losses

Ms. Suzanne Morph is a high school teacher. To help finance the annual family vacation, she has been growing zucchinis for sale in a little plot next to her house. Her investment in time and money in this endeavor has been small, but the growing conditions are ideal for zucchinis. Although she has no farming background, in most years she has made a small profit selling at the weekly farmers' market for two months in the summer. However, she incurred a loss in 2019 of $18,700 due to a lawsuit claiming her zucchinis poisoned a customer. How much of this loss is deductible in her 2019 tax return? Calculate any farm loss carry over available to her.

**SOLUTION available in print and online Study Guide.**

### Farming Income And Cash Basis Accounting

6-165. As previously noted in this Chapter, business income is generally computed on the basis of accrual accounting. A major exception to this is permitted in ITA 28 for taxpayers engaged in a farming or fishing business. They can elect to determine income on a cash basis.

6-166. As most farmers will have receivables and inventories in excess of their payables, the ability to calculate income on a cash basis has a general tendency to defer the payment of tax. While it is clear that the original intent of ITA 28 was to provide this form of relief to the farming industry, the government became concerned that taxpayers were using even bona fide farms, in contrast to those described previously as hobby farms, as tax shelters, particularly in years when losses were incurred.

6-167. The remedy to this problem that has evolved is to require an inventory adjustment in those cases where the use of the cash basis produces a loss. This requires the lesser of the amount of the cash basis loss and the value of purchased inventories to be used to reduce the loss that arose using the cash basis calculation. The tax rules for farming income can be very complex. There is limited coverage of farm loss carry overs in Chapter 11. However detailed coverage of farming income is beyond the scope of this text.

6-168. Although the procedures involved are complicated by a number of factors, a simple example will illustrate the basic calculation:

**EXAMPLE** Garfield Farms begins operations on January 1, 2019. At this time, it has no Accounts Receivable, Accounts Payable, or Inventories. The Loss on a cash basis for the year ending December 31, 2019 amounted to $600,000. On December 31, 2019, Garfield Farms has the following:

- Accounts Receivable of $2,000,000
- Inventories that total $1,400,000
- Accounts Payable of $750,000

**ANALYSIS - Inventory Adjustment** A mandatory inventory adjustment of $600,000 (lesser of the $600,000 loss and $1,400,000 in inventories) would be used to reduce the cash basis loss of $600,000, resulting in a final income figure for tax purposes of nil.

**ANALYSIS - Accrual Basis Income** If cash basis accounting was not used, normal accrual basis income for the year ending December 31, 2019 would amount to $2,050,000 (-$600,000 + $2,000,000 + $1,400,000 - $750,000).

### *Lifetime Capital Gains Deduction Available For Farm Properties*

6-169. One of the most important tax benefits available to Canadian residents is the lifetime capital gains deduction. This deduction can provide for up to $1 million of capital gains on dispositions of qualified farm properties and fishing properties to be received tax free. This complex provision, which can also apply to gains on the shares of qualified small business corporations, is discussed in detail in Chapter 11.

## Professional Income (Billed Basis Of Recognition)

### *The Problem*

6-170. When a business involves the delivery of professional services, clients are often billed on a periodic basis, normally after a block of work has been completed. This block of work may be task defined (e.g., billing when a client's tax return is finished), time defined (e.g., billing on a monthly basis), or on some other basis. However, in the majority of professional income situations, billing does not occur until after the work has been completed. The following simple example illustrates this situation:

**EXAMPLE** Joan Martin initiated her law practice on January 1, 2019. During the year ending December 31, 2019, she provides services to clients that have a value of $175,000. She bills clients for $150,000 of this amount, collecting a total of $120,000 of the billed amount. At December 31, 2019, she has unbilled work in process of $25,000 ($175,000 - $150,000).

**ANALYSIS** As business income is based on accrual accounting, in the absence of a special provision, Joan would have to recognize revenues based on all of the services provided. This amount would be $175,000, including the unbilled work in process of $25,000. The amount collected has no effect on the result using accrual accounting.

6-171. For many years, ITA 34 provided a special provision which allowed certain professionals to exclude unbilled work in process from their revenues. This provision was available to accountants, dentists, lawyers, medical doctors and veterinarians. It was not available to other professionals such as architects, engineers, and management consultants.

### Change In Legislation

6-172. In 2017, the government concluded that this provision was no longer appropriate. While ITA 34 was repealed, a transitional provision, applicable to taxation years that began after 2017, was provided in order to soften the blow to those professionals that were using this provision. ITA 10(14.1) allows these professionals to phase out the use of the billed basis over a 5 year period. For businesses that use the calendar year as their taxation year, this would be the 5 years 2018 through 2022. In our examples, we will only consider businesses that use calendar year for their fiscal period.

6-173. Under this provision, taxpayers have to include unbilled work in process in their income according to the following schedule:

- 20 percent in the year ending December 31, 2018
- 40 percent in the year ending December 31, 2019
- 60 percent in the year ending December 31, 2020
- 80 percent in the year ending December 31, 2021
- 100 percent in the year ending December 31, 2022

6-174. To illustrate this, consider the following example:

**EXAMPLE** Ms. Shelly Hart begins her new accounting practice on January 1, 2019. During the year ending December 31, 2019, she records 2,050 billable hours. Her regular billing rate is $100 per hour and, at the end of her first year, she has billed 1,750 hours, or a total of $175,000. Her unbilled work in process at the end of 2019 is $30,000 [($100)(2,050 - 1,750)].

During the year ending December 31, 2020, she records 1,900 billable hours. Her billing rate is unchanged at $100 per hour and she bills 1,700 of the hours worked in 2020, in addition to the unbilled 2019 work in process.

**ANALYSIS** Using the billed basis of recognition, for 2019, Ms. Hart will include in income all of her billed receivables, plus 40 percent of the unbilled amounts, a total of $187,000 [$175,000 + (40%)($30,000)].

For 2020, Ms. Hart's income inclusion will be calculated as follows:

| | |
|---|---|
| Unrecognized Work In Process From 2019 [(100% - 40%)($30,000)] | $ 18,000 |
| 2020 Billings [($100)(1,700)] | 170,000 |
| 2020 Unbilled Work In Process [(60%)($100)(1,900 - 1,700)] | 12,000 |
| Total 2020 Income Inclusion | $200,000 |

## Exercise Six - 14

**Subject:** Professional Income (Billed Basis Of Recognition)

Jack Winters is a lawyer who has always used the billed basis of revenue recognition. On January 1, 2019, he had unbilled work in process of $35,000. During the year ending December 31, 2019, he bills the $35,000 work in process balance from January 1 and his work results in potential billings of $245,000. Of this amount, $185,000 has been billed during 2019. During the year ending December 31, 2020, he bills the work in process balance from January 1, 2020 and his work during the year results in potential billings of $285,000. Of this amount, $247,000 has been billed during 2020. Calculate his inclusion in net business income for 2019 and 2020.

**SOLUTION available in print and online Study Guide.**

**We suggest you work Self Study Problems Six-12 and Six-13 at this point.**

## Sale Of A Business

### General Rules

6-175. ITA 22 through 25 contain a group of provisions that apply when a person sells substantially all of the assets that have been used to carry on a business. The need for special provisions here reflects the fact that, because the business in its entirety is considered to be a capital asset, the gains or losses that result from the sale would be considered to be capital in nature.

6-176. While this capital gains treatment may be appropriate with respect to many of the assets of a business, gains and losses on the sale of some assets would not be considered capital in nature. In particular, a separate sale of either inventories or accounts receivable would normally result in business income or loss, not a capital gain or loss. Because of this anomaly, there are special provisions with respect to gains and losses on the disposition of these assets when they are sold as part of a business disposition.

### Inventories

6-177. ITA 23 provides that when inventories are included in the sale of a business, the sale will be viewed as being in the ordinary course of carrying on the business. This means that any gain or loss resulting from a sale of inventory will be treated as business income or loss. No election is required to produce this result.

### Accounts Receivable - ITA 22 Election

6-178. In dealing with the sale of accounts receivable as part of the disposition of a business, there are two basic problems. The first is that, if the receivables are worth less than their carrying value, the difference will be considered to be a capital loss. This means that only one-half of the amount of the loss will be deductible, and that the deduction can only be made against taxable capital gains.

6-179. The second problem is that bad debts cannot be deducted, or a reserve established, unless the receivables have been previously included in income. In the case of the sale of a business, this would create a problem for the purchaser in that the purchased receivables would never have been included in his income.

6-180. To deal with these two problems, ITA 22 provides for a joint election by the vendor and purchaser of the business. If the election is made, the vendor of the business can treat any loss on the receivables as a fully deductible business loss. For the purchaser of the business, the election will require that he include the difference between the face value of the receivables acquired and the price paid for them in income. However, he can then deduct any amounts that prove to be uncollectible. The following example illustrates the application of this election.

> **EXAMPLE** Mr. Whitney agrees to buy Mr. Blackmore's business. As part of the transaction, Mr. Whitney acquires Mr. Blackmore's trade receivables for $25,000. These receivables have a face value of $30,000 and Mr. Blackmore has deducted a $4,000 reserve for doubtful debts with respect to these receivables.
>
> **ANALYSIS - Vendor** Whether or not the election is made under ITA 22, Mr. Blackmore will have to include the $4,000 reserve in business income. If no election is made, he will then record an allowable capital loss of $2,500 [(1/2)($30,000 - $25,000)]. Assuming Mr. Blackmore has taxable capital gains against which the $2,500 loss can be deducted, the transaction will result in a net inclusion in income of $1,500 ($4,000 - $2,500).
>
> In contrast, if the ITA 22 election is made, Mr. Blackmore would still have to include the $4,000 reserve in income. However, it will be offset by a business loss of $5,000 on the sale of the receivables, a distinct improvement over the results with no election. Under this approach, there will be a net deduction from income of $1,000.

**ANALYSIS - Purchaser** From the point of view of Mr. Whitney, if no election is made, he will record the receivables as a $25,000 capital asset. If more or less than $25,000 is actually collected, the difference will be a capital gain or a capital loss.

If, however, the ITA 22 election is made, he will have to include the $5,000 difference between the face value and the price paid in income, in the year the receivables are acquired. Subsequent to the sale, any difference between the $30,000 face value of the receivables and amounts actually collected will be fully deductible in the calculation of net business income. Mr. Whitney could establish a new reserve for doubtful debts related to the purchased receivables that are still outstanding at the year end. If the amount collected is equal to $25,000, Mr. Whitney will be in exactly the same position, whether or not the election is made. If more than $25,000 is collected, he will be worse off with the election because 100 percent rather than one-half of the excess will be taxable. Correspondingly, if less than $25,000 is collected, he will be better off with the election as the shortfall will be fully deductible.

**Exercise Six - 15**

**Subject:** Sale Of Receivables

Mr. Donato Nero is selling his unincorporated business during 2019. Included in his assets are accounts receivable with a face value of $53,450. He and the purchaser of the business, Mr. Labelle, have agreed that the net realizable value of these receivables is $48,200. In 2018, Mr. Nero deducted a reserve for doubtful debts of $3,800. Determine the tax consequences of the sale of these receivables for Mr. Nero and Mr. Labelle, provided that they jointly elect under ITA 22.

**SOLUTION available in print and online Study Guide.**

**We suggest you work Self Study Problems Six-14, 15 and 16 at this point.**

## Scientific Research And Experimental Development

6-181. In an effort to encourage expenditures in this area of business activity, special provisions for scientific research and experimental development (SR&ED) expenditures are provided in ITA 37 as well as other Sections of the *Income Tax Act*. As SR&ED expenditures are usually made by corporations, our coverage of them is found in Chapter 14, "Other Issues In Corporate Taxation".

**Additional Supplementary Self Study Problems Are Available Online.**

# Key Terms Used In This Chapter

6-182. The following is a list of the key terms used in this Chapter. These terms, and their meanings, are compiled in the Glossary located at the back of the Study Guide.

| | |
|---|---|
| Accrual Basis | Inventory |
| Allowable Capital Loss | Net Business Income |
| Billed Basis | Net Income |
| Business | Property Income |
| Business Income | Reserve |
| Capital Asset | Restricted Farm Loss |
| Capital Gain/Loss | Restrictive Covenant |

| | |
|---|---|
| Cash Basis | Soft Costs |
| Crowdfunding | Specified Shareholder [ITA 18(5)] |
| Fiscal Period | Taxable Capital Gain |
| GAAP | Taxation Year |
| Hobby Farmer | Thin Capitalization |

## References

6-183. For more detailed study of the material in this Chapter, we would refer you to the following:

| | |
|---|---|
| ITA 9 | Income |
| ITA 10 | Valuation Of Inventory |
| ITA 12 | Income Inclusions |
| ITA 18 | General Limitations [On Deductions] |
| ITA 20 | Deductions Permitted In Computing Income From Business Or Property |
| ITA 22 | Sale Of Accounts Receivable |
| ITA 23 | Sale Of Inventory |
| ITA 24 | Ceasing To Carry On Business |
| ITA 28 | Farming Or Fishing Business |
| ITA 31 | Loss From Farming Where Chief Source Of Income Not Farming |
| ITA 67 | General Limitation Re Expenses |
| ITA 67.1 | Expenses For Food |
| ITA 67.2 | Interest On Money Borrowed For Passenger Vehicle |
| ITA 67.3 | Limitation Re Cost Of Leasing Passenger Vehicle |
| ITA 67.5 | Non-Deductibility Of Illegal Payments |
| ITA 67.6 | Non-Deductibility Of Fines And Penalties |
| S3-F9-C1 | Lottery Winnings, Miscellaneous Receipts, and Income (and Losses) from Crime |
| S4-F2-C1 | Deductibility Of Fines Or Penalties |
| S4-F2-C2 | Business Use of Home Expenses |
| 5S-F4-C1 | Income Reporting Currency |
| S4-F11-C1 | Meaning Of Farming And Farming Business |
| IT-51R2 | Supplies On Hand At The End Of A Fiscal Period |
| IT-99R5 | Legal And Accounting Fees (Consolidated) |
| IT-154R | Special Reserves |
| IT-188R | Sale Of Accounts Receivable |
| IT-218R | Profit, Capital Gains And Losses From The Sale Of Real Estate |
| IT-287R2 | Sale Of Inventory |
| IT-322R | Farm Losses |
| IT-357R2 | Expenses Of Training |
| IT-359R2 | Premiums And Other Amounts With Respect To Leases |
| IT-364 | Commencement Of Business Operations |
| IT-417R2 | Prepaid Expenses And Deferred Charges |
| IT-433R | Farming Or Fishing - Use Of Cash Method |
| IT-442R | Bad Debts And Reserves For Doubtful Debts |
| IT-457 | Election By Professionals To Exclude Work In Progress From Income |
| IT-459 | Adventure Or Concern In The Nature Of Trade |
| IT-473R | Inventory Valuation |
| IT-475 | Expenditures On Research And For Business Expansion |
| IT-479R | Transactions In Securities |
| IT-487 | General Limitation On Deduction of Outlays or Expenses |
| IT-518R | Food, Beverages And Entertainment Expenses |
| IT-521R | Motor Vehicle Expenses Claimed By Self-Employed Individuals |
| IT-525R | Performing Artists (Consolidated) |

# Problems For Self Study (Online)

To provide practice in problem solving, there are Self Study and Supplementary Self Study problems available on MyLab Accounting.

Within the text we have provided an indication of when it would be appropriate to work each Self Study problem. The detailed solutions for Self Study problems can be found in the print and online Study Guide.

We provide the Supplementary Self Study problems for those who would like additional practice in problem solving. The detailed solutions for the Supplementary Self Study problems are available online, not in the Study Guide.

The .PDF file "Self Study Problems for Volume 1" on MyLab contains the following for Chapter 6:

- 16 Self Study problems,
- 6 Supplementary Self Study problems, and
- detailed solutions for the Supplementary Self Study problems.

# Assignment Problems

(The solutions for these problems are only available in the solutions manual that has been provided to your instructor.)

### *Assignment Problem Six - 1*

***(Reserves)***

Olivia Smith is the owner of an unincorporated business that does landscaping. The business began operations on January 2, 2019 and has a December 31 year end. The 2019 and 2020 results for the business can be described as follows:

> **2019** During its first year, the business had sales of delivered merchandise and services totaling $185,000. Of this total, $65,000 had not been collected on December 31, 2019. Olivia anticipates that $5,000 of these sales will be uncollectible.
>
> In addition to these sales of delivered merchandise and services, she received $23,000 in advances for merchandise to be delivered in 2020.
>
> Olivia purchased a large supply of landscaping materials from the trustee of a bankrupt landscaping business at a very good price. Since she is unlikely to use them in the next few years, she has arranged to sell these materials for $50,000. These materials have a cost of $40,000, resulting in a total gross profit of $10,000. Because of the size of this sale, she has agreed to accept a down payment of $30,000, followed by two annual instalments of $10,000. The instalments are due on December 31, 2020 and December 31, 2021.
>
> **2020** During 2020, $5,500 of accounts receivable had to be written off. All of the merchandise for which advances had been received was delivered and the $10,000 instalment on the 2019 sale of landscaping materials was received.
>
> Sales of delivered merchandise and services totaled $240,000. Of this total, $50,000 was still on account at December 31, 2020. Olivia anticipates that $3,500 of this amount will be uncollectible.
>
> In addition to the 2020 sales of delivered merchandise and services, she receives $13,400 in advances for merchandise to be delivered in 2021.

**Required:** How would the preceding information affect the calculation of Olivia Smith's business income for the 2019 and 2020 taxation years? Include the full details of your calculations, not just the net result for each year.

### Assignment Problem Six - 2

#### (Deductible Automobile Costs And Taxable Benefit)

Bob Neat is the sole shareholder and only employee of Bob's Bookkeeping Services Ltd., a Canadian controlled private corporation with a December 31 year end. The Company provides on-site bookkeeping services to a number of clients in the greater Toronto area.

As Bob must travel extensively to service clients, the Company provides him with a vehicle to be used in his work. As Bob does not personally own a vehicle, he also uses the vehicle for personal travel. During 2019, two different vehicles were provided:

> **Ford Focus** During the period January 1, 2019 through April 30, 2019, Bob had use of a Ford Focus that had been purchased in 2018 for $23,600. As of January 1, 2019, the Class 10 UCC balance was $20,060. During this period, Bob drove the car a total of 31,000 kilometers, 18,000 of which related to his work for the Company. On April 30, 2019, the car was sold for proceeds of $18,200.

> **Mercedes E-Class Sedan** As the business was becoming very profitable, Bob decided he deserved a better equipped and more comfortable vehicle. On May 1, 2019, the Company acquires a Mercedes E-Class sedan for $52,000. During the period May 1 through December 31, 2019, Bob drives the car a total of 42,000 kilometers, 23,000 of which involved personal activities.

These were the only vehicles owned by Bob's Bookkeeping Services during 2019. Bob had one of these vehicles available to him at all times during 2019.

Throughout 2019, the Company paid for all of the operating costs of both vehicles, a total of $17,460.

**Required:** Determine the following:

A. The tax consequences to Bob's Bookkeeping Services Ltd. that result from owning and selling the Ford Focus and owning the Mercedes E-Class sedan during 2019.

B. The minimum amount of the taxable benefit that Bob will have to include in his Net Income For Tax Purposes for 2019.

Ignore HST considerations in your solution.

### Assignment Problem Six - 3

#### (Employer Provided Vs. Employee Owned Vehicle)

Jordan Nash has an employment contract with Emmitt Industries, a Canadian public company. The contract commences as of January 1, 2019 and covers the three years ending December 31, 2021. His income is well above the floor of the maximum tax bracket and, given this, the combined federal/provincial tax rate that is effective for any additional income or deductions is 50 percent.

Jordan will require a vehicle for use in his employment duties. Because of the nature of his work, a luxury vehicle is required and he and Emmitt have agreed that a $125,000 BMW 750 would be an appropriate choice. Based on this decision, Emmitt has offered Jordan the following two alternatives. Emmitt is indifferent as to which alternative he chooses.

> **Alternative 1** The Company will provide the automobile and pay all of the operating costs, including those related to Jordan's personal use of the vehicle. The automobile will be available to Jordan on a full time basis throughout the three year term of his employment contract. It will be returned to the Company at the end of that period.

**Alternative 2** The Company will provide Jordan with an interest free loan for $125,000 in order to facilitate the purchase of the vehicle. No payments are required on the loan and it must be repaid in full on December 31, 2021. Jordan will pay all of the operating costs for the vehicle and, to assist with these costs, the Company will provide Jordan with an allowance of $2,000 per month. Jordan will retain ownership of the vehicle at the end of his employment contract.

In order to make a decision on these alternatives, Jordan recognizes the need to make estimates of both operating costs and usage of the automobile. The estimates that he will use in making his decision are as follows:

- He anticipates driving the vehicle 65,000 kilometers each year, with 18,000 of these kilometers being for personal usage.
- If he owns the vehicle, he estimates that his operating costs will average $0.32 per kilometer over the three year term of his employment contract. At the end of the employment contract, he will sell the vehicle and estimates that the proceeds will be $52,000.

Assume that the prescribed rate for the operating cost benefit is $0.28 per kilometer in all of the years 2019 through 2021, and that the prescribed interest rate is 2 percent throughout this period.

**Required:** Advise Jordan as to which of the alternatives he should accept. Base your decision on the undiscounted cash flows associated with the two alternatives. Ignore GST/HST considerations.

## *Assignment Problem Six - 4*

### *(Valuation Of Business Inventories)*

Jasper Retailers Inc. began business on January 1 of the current year. Purchases during the year are as follows:

| Date | Quantity | Price | Total Cost |
|---|---|---|---|
| January 1 | 15,000 | $10.00 | $ 150,000 |
| March 1 | 35,000 | $11.00 | 385,000 |
| June 15 | 42,000 | $11.50 | 483,000 |
| September 1 | 27,000 | $12.00 | 324,000 |
| October 1 | 17,000 | $12.50 | 212,500 |
| Totals | 136,000 | | $1,554,500 |

On December 31, the end of the Company's taxation year, the inventory on hand amounts to 22,000 units. It is estimated that these units have a replacement cost of $10.50 per unit and a net realizable value of $11.75 per unit.

**Required:** Calculate the various closing inventory values that could be used to determine business income for tax purposes. Your answer should indicate the valuation method being used, as well as the resulting value.

## *Assignment Problem Six - 5*

### *(Proprietorship - Reverse Business Income)*

Several years ago George Danton, after being laid off, decided he could benefit from his love of flowers and fascination for viewing dead bodies by opening a flower shop. This allowed him to make frequent visits to the various funeral homes in the area. The shop uses a December 31 taxation year. The business has been a great success, both in terms of being profitable and in enhancing George's enjoyment of life (and death).

As George is the sole proprietor of the business, he has had no need to report income figures to anyone. Given this, he has always used tax procedures to calculate the annual income of the business. For the year ending December 31, 2019, using his usual tax procedures, George has calculated his net business income to be $613,300.

Because a very large funeral home has opened in a suburb, George has decided to expand into that area. To do this, he needs a mortgage on the property that will be acquired for operations in the new location. To his dismay, he finds that the lender is insisting on financial statements prepared in accordance with generally accepted accounting principles (GAAP).

As he has no knowledge of GAAP, he has asked you to determine the amount of GAAP based income that Danton's Flowers has earned for the 2019 year.

**Other Information:**

1. In the net business income calculation based on tax procedures, George deducted $8,450 in business meals and entertainment costs.
2. Because his shop is near the U.S. border, George spent $7,420 advertising on a U.S. television station. The commercials were directed at Canadian resident viewers.
3. Because of a broken window during early December, live flowers costing $6,320 were destroyed.
4. During 2019, George paid a high level Canada Customs official a total of $19,460 in cash. In return, he received priority clearance for all his imports, as well as clearance for live plant imports that should have been restricted. Since this is an illegal payment to a government official, a.k.a., a bribe, it is not deductible for tax purposes.
5. During 2019, the business made $6,300 in contributions to the Hospice Association. This association is a registered charity.
6. For tax purposes, the ending inventories of the business were carried at the market value of $86,300. Their total cost, determined on a FIFO basis, was $73,150.
7. George deducted $51,400, the maximum amount of CCA that was available for the year. You have determined that amortization under GAAP would have been $46,350.
8. While George agreed to spend $6,070 on uniforms for the local men's softball team, the team refused to play if Danton's Flowers was printed on the front of their shirts. George finally accepted the use of the initials DF in a strong, bold font instead. He was influenced by the fact that in recent years the team had experienced numerous injuries requiring hospitalization of players and spectators. This was the result of wild throwing due to poor lighting of the playing field and the periodic 2 for 1 beer sales in the park.
9. George owns a delivery vehicle which cost $29,000. It is the only Class 10 asset of the business and, as of January 1, 2019, the Class had a UCC balance of $8,455. Under GAAP, its net book value at the time of the sale would have been $14,500. During the year, the vehicle is sold for $4,300 and replaced with a leased vehicle. The leasing costs are fully deductible for tax purposes.
10. In December, 2019, George spent $15,200 on landscaping the grounds around his store. Given the late date at which this work was done, no amortization would be required for accounting purposes with respect to these costs for 2019. It is expected that these landscaping improvements will last at least 10 years.
11. During 2019, George sold Class 8 assets for $21,300. These assets had a capital cost of $32,600 and were not the last assets in Class 8. There was a positive balance in Class 8 at the end of the year. If these assets had been subject to GAAP amortization, their net book value would have been $18,300.
12. As the business is unincorporated, no taxes were deducted in calculating Net Income.

**Required:** Determine the 2019 GAAP based net income for Danton's Flowers. Do not include in your calculations any tax that George will have to pay on this income. If you do not make an adjustment for some of the items included in other information, indicate why this is the case.

### Assignment Problem Six - 6

#### (Partnership - Business Income, Employee vs. Self-Employed)

Richmond Consultants is a partnership with three architects as members. The partnership provides services throughout their local region. The partnership began operations on July 1, of the current year.

While the partners themselves will undertake much of the work required by their various contracts, some smaller projects may be contracted out. These outside contracts will require the architect to undertake a well defined project for a fixed fee, plus related expenses. The partners are uncertain as to the need for source deductions (income tax, EI and CPP contributions) on amounts paid to these individuals.

The partners have hired you to assist them with some of the tax issues that will arise in the operation of the partnership.

**Required:**

A. Explain to the partners how business income from partnerships is taxed in Canada.

B. Explain to the partners what choice they have in selecting a year end for their business.

C. Advise the partners on whether source deductions will be required on the amounts paid to the outside architects.

### Assignment Problem Six - 7

#### (Proprietorship - Business Income With CCA)

Karla Sandone is a successful photographer who specializes in photographs and videos of beloved pets. She operates her studio out of a building which she purchased several years ago for $375,000. Of this total, it is estimated that $100,000 reflects the value of the land. It was a new building when she acquired it, her business uses 100 percent of the building, and it was allocated to a separate Class 1. On January 1, 2019, the building has a UCC of $230,712.

Karla prides herself on using the very latest camera and video gear. After receiving a sizable inheritance a few years ago, she can afford to indulge herself in fulfilling this goal. Karla has an agreement with a camera shop to purchase all her equipment through them at a 10 percent discount. In return, they will give her 20 percent of her purchase price on trade-ins that are less than a year old. Under this agreement, Karla traded in equipment with a capital cost of $27,000 and purchased new equipment for $85,000 during 2019. Her equipment had a January 1, 2019 UCC of $25,100.

On her birthday in 2018, Karla bought herself a $120,000 BMW that she used largely for business purposes. After an unfortunate incident involving a nervous Great Dane she was transporting to her studio in the BMW, Karla trades it in for $60,000 on January 2, 2019. The January 1, 2019 UCC for the BMW was $25,500. She then purchases two vehicles:

- a used sports car for $29,000 that is solely for personal use and
- a new van designed to carry animals for $80,000 that is primarily for business use.

During 2019, the van is driven 35,000 kilometers, only 1,000 of which were for personal use in transporting her own pets and misbehaving children. The operating costs of the van for the year were $7,900.

During late December, 2018, an altercation between a pot belly pig and a baby tiger cub destroyed her computer equipment. Because she was at fault through lack of supervision, she did not make a claim on her insurance and wrote off the balance in the CCA Class during 2018.

Other asset acquisitions during 2019 are as follows:

| | |
|---|---|
| New Computers And Photo/Poster Printer | $ 20,750 |
| Applications Software | 3,480 |
| Client List From Retiring Pet Photographer | 28,000 |

Other 2019 costs of operating her business, determined on an accrual basis, are as follows:

| | |
|---|---|
| Building Operating Costs | $31,300 |
| Payments To Assistants (Note) | 51,100 |
| Office And Photographic Supplies | 11,600 |
| Miscellaneous Office Costs | 8,400 |
| Pet Toys And Video Props | 2,700 |
| Premium Pet Food And Drinks | 3,000 |
| Meals With Clients Who Are Human | 10,500 |

**Note** The payments include $30,000 paid to her 16 year old son. He takes care of her web site with its extensive photo/video gallery and keeps up and increases her substantial social media presence.

During 2019, the revenues of Karla's practice total $285,800.

**Required**: Calculate the minimum net business income Karla would include in her 2019 personal income tax return. In preparing your solution, ignore GST and PST implications and her CPP liability.

### *Assignment Problem Six - 8*

#### *(Work Space In The Home Costs And CCA)*

Olin Packett has decided that he must find a way to earn additional income. While he has a reasonable salary from his current employment, it is not nearly adequate to provide for the luxury items that he feels he really should be enjoying.

After consulting his know-it-all brother, he concludes that a home-based online business which provides premium quality organic nut, fruit and candy products would do well. He opens his website for business on March 1, 2019.

He will operate this business out of his home. This property was acquired during 2018 at a total cost of $467,000, of which $130,000 can be attributed to the value of the land on which the house is situated. The business will have exclusive use of 23 percent of the floor space in Olin's home. Olin does not believe that the value of the property has changed significantly since its acquisition.

Olin was not prepared for the immediate large orders he receives as he thought business would be slow to start. On March 15, 2019, he acquires office, shipping and storage furniture and shelving at a cost of $42,000. Later that month, on March 27, he acquires an all-in-one computer at a cost of $1,940, along with business software at a cost of $467. He also arranges to have a separate phone line installed for the use of the business. As he meets with more suppliers and clients, he purchases a tablet for $400 on June 30 to enable him to operate more efficiently outside his home.

The phone package that he acquires includes the use of a toll-free number for his customers, as well as unlimited long distance calls in Canada.

For the year ending December 31, 2019, costs associated with owning his home are as follows:

| | |
|---|---|
| Utilities For Home (Heat, Light, And Water) | $ 2,650 |
| Mortgage Interest Paid | 14,600 |
| House Insurance | 1,300 |
| Property Taxes | 7,005 |
| Repairs And Maintenance For Home* | 13,400 |
| Total | $38,955 |

*Of the repair costs, $12,200 represents the cost of replacing the aging cedar siding on the home with metal siding. The remaining $1,200 ($13,400 - $12,200) involves ordinary day to day maintenance (e.g., replacing light bulbs and furnace filters).

During the period March 1, 2019 through December 31, 2019, his sales total $233,000. Costs associated with these sales are as follows:

| | |
|---|---|
| Cost Of Merchandise Purchased | $116,014 |
| Unsold Merchandise At December 31, 2019 | 16,327 |
| Packaging Materials | 4,206 |
| Shipping Costs | 8,354 |
| Office Supplies | 3,210 |
| Telephone (Total Charge For The Period) | 862 |
| Advertising In Various Canadian Media | 6,438 |
| Insurance On Business Inventories | 423 |
| Cleaning Services For Office And Shipping Space | 3,250 |
| Meals And Entertainment For Suppliers | 2,450 |
| Credit Card Fees | 2,300 |
| Estimated Bad Debts | 1,450 |

Olin's parents have been helping him by taking orders and packaging product for shipping. They refuse any payment for their work as they are both bored with the retirement life and, unlike their son, feel they have more than adequate income for their modest needs.

**Required:**

A. Can Olin deduct work space in the home costs? Briefly explain your conclusion.

B. Compute the minimum net business income or loss that Olin must report in his 2019 personal income tax return.

C. Briefly describe any issues that should be discussed with Olin concerning the work space in his home and business costs.

### Assignment Problem Six - 9

#### (Corporate Business Income With CCA)

Angie's Amazing Getups Incorporated is a Canadian controlled private corporation with a head office in London, Ontario. The company is a manufacturer of high end custom costumes and makeup used in movie and theatre productions with sales in Canada and the U.S.

The company started in business in 2016 when the sole shareholder, Angela Q. Snodgrass, was photographed by the paparazzi after a particularly enthusiastic night of partying. When Angela saw herself on the front page of every tabloid newspaper the next day, she knew that fame was not for her. Since Angela was a highly trained clothing designer and makeup artist, she felt she would be able to use those skills to start her own business and keep out of the limelight.

In November, 2019, after discovering that her bookkeeper, Ponzi Madoff, had been defrauding her, Angela fired him and took over the bookkeeping responsibilities herself, despite having a limited knowledge of accounting. She has produced the following Income Statement and miscellaneous financial information for the year ended December 31, 2019 and needs your help.

**Angie's Amazing Getups Incorporated**
**Income Statement**
**Year Ending December 31, 2019**

| | | |
|---|---|---|
| Sales | | $7,578,903 |
| Cost Of Goods Sold | | ( 5,468,752) |
| Gross profit | | $2,110,151 |
| Expenses: | | |
| General And Administrative Expenses | ($852,000) | |
| Amortization Expense | ( 550,000) | |
| Interest | ( 8,500) | ( 1,410,500) |
| Operating Income | | $ 699,651 |
| Other Income: | | |
| Loss On Disposal Of Limited Life Licence | | ( 17,000) |
| Interest Income | | 110,532 |
| Income Before Income Taxes | | $ 793,183 |
| Income Taxes | | |
| Current | ($182,000) | |
| Future | ( 35,000) | ( 217,000) |
| Net Income | | $ 576,183 |

During your review of Angela's work and last year's tax return for the corporation, you have made the following notes.

1. In the accounting records, the Allowance For Doubtful Accounts was $25,000 at December 31, 2019, and $20,000 at December 31, 2018. During 2019, the company had actual write-offs of $11,750. As a result, the accounting Bad Debt Expense was $16,750. This amount is included in General and Administrative Expenses on the Income Statement.

   A review of the listing of receivables (for tax purposes), indicates that the actual items that may be uncollectible total $15,000 at December 31, 2019. In 2018, the company deducted a reserve for bad debts of $13,000 for tax purposes.

2. General And Administrative Expenses include:

| | |
|---|---|
| Donations To Registered Charities | $ 27,000 |
| Accrued Bonuses - Accrued September 1, 2019, Paid June 15, 2020 | 78,000 |
| Meals And Entertainment Costs: | |
| $1,000 Per Month For Premium Membership At Golf Club For Angie | 12,000 |
| $200 Per Month For Memberships At Golf Club For Salespeople | 2,400 |
| $32,000 For Meals While Entertaining Clients | 32,000 |
| $5,000 In Food Costs For Angie's Personal Chef For Her Meals At Home | 5,000 |
| $6,000 For Annual Summer BBQ For All Staff | 6,000 |
| Sponsorship Of Various Theatre Productions That Use Angie's Costumes | 100,000 |
| Advertising In A U.S. Theatre Magazine Directed At U.S. Clients | 15,000 |
| New Software Purchased October 1, 2019 | |
| ($13,000 For Applications And $25,000 For Systems) | 38,000 |
| Accounting And Legal Fees For Amended Articles Of Incorporation | 6,000 |
| Costs To Attend Annual Convention Of Costume Designers Held In Thailand | 17,000 |

3. Interest Expense consists of the following:

| | |
|---|---|
| Interest Expense - Operations | $5,000 |
| Penalty And Interest For Late And Insufficient Instalment Payments | 2,000 |
| Interest On Late Payment Of Municipal Property Taxes | 1,500 |

4. Travel costs (included in General and Administrative costs) include both air travel and travel reimbursement to employees for business travel. The company policy is to reimburse employees $0.62 per kilometer for the business use of their automobiles. During the year, seven employees each drove 4,000 kilometers on employment related activities and one employee drove 7,500 kilometers. None of the kilometer based allowances are required to be included in the income of the employees.

5. Maximum CCA has always been taken on all assets. The undepreciated capital cost balances at January 1, 2019 were as follows:

| | |
|---|---|
| Class 1 (4%) | $650,000 |
| Class 8 | 95,000 |
| Class 10.1 | 17,850 |
| Class 14 | 68,000 |
| Class 14.1 | Nil |
| Class 44 | 65,000 |
| Class 53 | 135,000 |

6. During 2019, a limited life licence to produce costumes based on a popular theme park was sold for $63,000. The original cost of this licence was $95,000 and its net book value at the time of sale was $80,000. The licence was the only asset in Class 14.

7. Purchases and sales of equipment and other capital assets made during 2019 were as follows (note: some items are discussed in other sections of this problem). All amounts were capitalized for accounting purposes:

   a. The company purchased land and constructed a new building on it during the year. The building will be used 95% for manufacturing and processing. The cost of the land was $350,000, and the building cost $475,000 to construct.
   b. The company purchased a new set of furniture for the reception area for $1,200.
   c. Some outdated desks used by the finance department with a cost of $5,000 were sold for proceeds of $3,500.
   d. Landscaping of the grounds around the new building cost $35,000. This amount was capitalized for accounting purposes.
   e. A company car for use by the president of the company was purchased for $90,000. This car replaced the only other existing company car, which was purchased in 2017 for $95,000. The old car was sold for $60,000.
   f. A fence around the new building, high enough to prevent the paparazzi from taking pictures of Angela while she was at the office cost $52,000.

8. The company sold some shares that had been purchased several years ago. The capital gain on these shares was $152,708. Angela didn't know how to account for this, so she credited the entire amount to retained earnings.

**Required:** Determine Angie's Amazing Getups Incorporated's minimum Net Income For Tax Purposes for the year ending December 31, 2019. Ignore GST/HST/PST implications.

## Assignment Problem Six - 10

### (Deductibility Of Business Expenses And CCA)

Lorna Jung is a psychiatrist whose private practice specializes in treating children with psychiatric disorders. Her husband, Alec Jung, was the president of a very successful mental health clinic until it was bought out last year. He is currently creating and testing recipes to be included in his new ground breaking BBQ cookbook.

Over the past two years, Lorna has been investigating the patient benefits of having a therapy dog as part of her practice and has amassed an extensive library of clinical studies that show the effectiveness of this therapy. She is convinced that the use of a therapy dog will be advantageous to many of her patients and will improve the rate of their recovery.

On January 2, 2019, after much research, Lorna purchased a Labradoodle puppy for $2,000 that she named Sigmund. This particular breed was designed to be used as therapy dogs and Sigmund's mother was a well established therapy dog.

Sigmund became an important part of the Jung family. Whenever Sigmund wasn't in training or at Lorna's office, Alec would take Sigmund for walks and to the dog park. As Alec currently has no source of income, he charged Lorna the going rate of $20 per 1 hour (minimum) walk. He plans to report this income on his tax return.

For the month of September, 2019, Sigmund accompanied Lorna to consultations with all her patients except for those few who had a fear of dogs. She saw an immediate improvement in the attitudes of almost all her patients. Some children who refused to speak with her, could describe their feelings when they addressed Sigmund.

As word of Lorna's success with her therapy dog treatments spread, new patients would register only if assured that Sigmund would be present.

On Lorna's website, she had two hourly rates. The one with Sigmund participating was 15 percent higher than the rate without Sigmund. By December 31, 2019, 70 percent of her patients were paying the higher rate with Sigmund.

On July 1, 2019, in anticipation of taking Sigmund to the office and patient's homes on a regular basis, Lorna signed a 3 year lease for a Lexus SUV with sufficient room in the back for a sturdy, well-padded dog crate.

The lease payments were $950 per month. The manufacturer's list price for the vehicle was $65,000. As the Jungs have two other vehicles, this SUV was used only for business purposes.

For the year ending December 31, 2019, Lorna spent the following amounts on Sigmund:

| | |
|---|---:|
| Food, including puppy vitamins and supplements | $2,600 |
| Veterinary fees | 800 |
| Therapy dog training course fees | 1,400 |
| Dog walking fees paid to Alec | 3,280 |
| Car lease for SUV [($950)(6)] | 5,700 |
| Operating expenses for SUV | 2,950 |
| Purchase of paw protectors (good for one winter) | 140 |
| Purchase of custom made protective clothing (estimated life of 3 years) | 820 |
| Dog crate | 400 |
| Total Dog-Related Expenditures | $18,090 |

Lorna's tax accountant informed her that Sigmund's original cost could not be written off as there was no specific CCA class for dogs and CCA Class 8, the usual catch-all class, specifically excluded animals.

In 2020, Lorna's parents were in a car accident that left them both severely injured. After much thought, she decided she had to close her practice in order to care for them and help in the long rehabilitation process.

Lorna knew that Sigmund would become depressed without patient interaction, so she sold Sigmund to Dr. Skinner, a psychiatrist she had known for years who already had a therapy dog and was looking to expand his practice. Although Lorna could not sell her patient list to Dr. Skinner due to confidentiality constraints, she e-mailed all her patients that Sigmund would be available at Dr. Skinner's office so he would soon see familiar faces there.

Dr. Skinner paid $8,700 for Sigmund. This included $200 for the protective clothing and the crate. He promised the Jungs unlimited visitation rights.

Due to her high income, Lorna always claims the maximum deductions available each year.

**Required:**

A. Lorna's accountant does not plan to deduct any dog-related expenditures other than the maximum allowable SUV expenses. Do you agree this is the appropriate course of action? Justify your conclusion.

B. Indicate how much of the preceding expenditures you feel Lorna should deduct in the calculation of business income for 2019.

C. Calculate the amount, if any, that will be included in Lorna's 2020 Net Income For Tax Purposes due to the sale of Sigmund.

Ignore all GST/HST considerations in your solution.

### *Assignment Problem Six - 11*

#### *(Deductible Business Expenses - Proprietorship)*

Dr. Sweet is a dentist with a well established practice in Smith Falls, Ontario. She has sought your advice regarding the deductibility of the following expenditures made during the current taxation year:

1. Insurance payments included a $680 premium for coverage of her office and contents, $1,800 for malpractice coverage, and $1,700 in life insurance premiums.
2. Payments were made to a collection agency in the amount of $1,250 for assistance in collecting past due amounts from patients.
3. Contributions of $600 were made to various registered charities.
4. Dr. Sweet paid a total of $18,000 to her husband for his services as a full time bookkeeper and receptionist.
5. A total of $4,600 was spent to attend a dental convention in Phoenix, Arizona. Dr. Sweet was accompanied by her husband and $1,500 of the total cost of the trip relates directly to him.
6. An amount of $1,000 was paid for membership in a racquets club. In addition, $1,300 was spent for court time, approximately 40 percent of which was for time spent playing with patients.
7. Dr. Sweet paid $1,200 in legal and accounting fees. These fees related to fighting a personal income tax reassessment for a previous tax year. The fight was not successful and, as a consequence, Dr. Sweet was required to pay additional taxes of $13,000, plus $1,600 in interest on the late payments.
8. During the year, Dr. Sweet spent $3,200 purchasing provincial lottery tickets.

**Required:** Advise Dr. Sweet with respect to the deductibility of the preceding expenditures in the calculation of Net Income For Tax Purposes. Explain your position on each expenditure.

## Assignment Problem Six - 12

### (Business Income With CCA - Billed Basis)

Carl Pomery is a Chartered Professional Accountant who is employed as a controller of a medium sized corporation. He has been married three times and is required to make support payments to each of his former spouses. Because of his need for additional income, he operates an unincorporated tax and accounting services business. This business has a December 31 year end and has been in operation for several years.

Carl purchased a new building in 2008. It has been used exclusively for non-residential purposes and was allocated to a separate Class when it was purchased. On January 1, 2019, the business has the following UCC balances:

| | |
|---|---|
| Class 1 Building | $242,000 |
| Class 8 Furniture And Fixtures | 72,000 |
| Class 10 Vehicle (Purchased For $19,600) | 16,660 |
| Class 14.1 | Nil |

During January, 2019, the Class 10 vehicle is involved in a serious accident, requiring it to be permanently taken off the road. The insurance proceeds are $14,600. On February 1, Carl replaces it with a vehicle with a manufacturer's list price of $34,000 that is leased for $525 per month. Both vehicles are used exclusively for business purposes.

During July, 2019, Carl replaces most of the furniture in his office. The old furniture has a capital cost of $23,000, while the new items cost $46,000. Carl receives a trade in allowance for the old furniture of $18,000.

Also during January 2019, Carl acquires a new computer for $2,500, along with applications software for $2,200.

During March, 2019, Carl acquires a client list from an accountant who is retiring. The cost of this list is $82,000.

On January 1, 2019, Carl had unbilled work-in-progress of $35,000. All of this work was billed during the year ending December 31, 2019. During 2019, his work consisted of 1,900 billable hours that will be invoiced for a total of $152,000. On December 31, 2019, he had unbilled work-in-progress of $56,000.

During 2019, the various costs of operating his business, determined on an accrual basis, are as follows:

| | |
|---|---|
| Building Operating Costs | $22,000 |
| Vehicle Operating Costs | 7,200 |
| Vehicle Lease Payments | 5,775 |
| Payments To Assistants | 24,000 |
| Miscellaneous Office Costs | 4,500 |
| Meals With Clients | 3,500 |

**Required**: Calculate the minimum net business income Carl would include in his 2019 personal income tax return. In preparing your solution, ignore PST and GST considerations.

## Assignment Problem Six - 13

### (ITA 22 Accounts Receivable Election)

Beckett Enterprises is an unincorporated business that has operated successfully for a number of years under the direction of its owner, Ms. Joan Close. However, in early 2019, she decides to dispose of the business and retire. She will sell all of the assets of the business to an unrelated party, Mr. John Phar.

The date of the disposition is February 1, 2019 and, on that date, the business has accounts receivable with a face value of $120,000. Because of anticipated bad debts, the realizable value of these receivables is estimated to be $107,000. In 2018, Ms. Close deducted a reserve

for doubtful debts in the amount of $8,000.

Beckett Enterprises has a December 31 year end. Mr. Phar will continue the business on an unincorporated basis and will also have a December 31 year end.

During the year ending December 31, 2019, $100,000 of the accounts receivable are collected, with the remainder being written off as non-recoverable.

Both Ms. Close and Mr. Phar have heard of an election under ITA 22 that may have some influence on the tax treatment of the transfer of accounts receivable. They would like to have your advice on this matter. They will both have significant capital gains in 2019.

**Required:** Indicate the tax effects, for both Ms. Close and Mr. Phar, of the disposition of the accounts receivable and the subsequent 2019 collections and write-offs, assuming:

A. that no election is made under ITA 22.

B. that they make an election under ITA 22.

## Assignment Problem Six - 14
### (Comprehensive Case Covering Chapters 1 to 6)

#### Family Information
Dorian Wilde is 42 years old and married to his high school sweetheart, Gloria. Gloria has Net Income For Tax Purposes and Taxable Income of $8,200. The income is from investments that she purchased with funds that she inherited.

Dorian and Gloria have two sons:

**Oscar** is 15 years old and in good health. He has income from part-time summer jobs of $8,460.

**Bart** is 21 years old, in good health, and attends university on a full time basis for 10 months of the year. All of his university costs are paid for by Dorian, including tuition of $8,700, textbook costs of $1,350, and residence fees of $9,250. Bart has income from investments of $7,400. The investments were acquired with funds he earned during his high school years. Bart has agreed to transfer his tuition credit to his father.

The family's medical expenses, all of which were paid for by Dorian, were as follows:

| | |
|---|---|
| Dorian | $ 1,350 |
| Gloria (Note 1) | 4,600 |
| Oscar | 1,250 |
| Bart | 3,125 |
| Total | $10,325 |

**Note 1** Gloria's medical expenses were the result of a liposuction procedure to deal with a cellulite problem that she has had since childhood.

#### Employment Information
Dorian is employed by a Canadian public company. His annual salary is $92,500, none of which involves commissions. His employer withholds the following amounts from his earnings:

| | |
|---|---|
| Registered Pension Plan Contributions (Note 2) | $5,600 |
| EI Premiums | 860 |
| CPP Contributions | 2,749 |
| Contributions To Unplanned Parenthood (Note 3) | 3,200 |

**Note 2** Dorian's employer makes a matching contribution of $5,600.

**Note 3** Unplanned Parenthood is a registered Canadian charity.

Dorian is provided with an automobile by his employer. The vehicle was purchased in 2018 for $40,000 and, on January 1, 2019, its UCC on the employer's books was $25,500. During 2019, the automobile is driven 51,000 kilometers, 28,000 of which are related to Dorian's employment duties. It was available to Dorian for 11 months during the year and, during the month that he did not use the car, the company required that it be returned to the company's garage.

During the year, Dorian received a travel allowance from his employer of $550 per month, an annual total of $6,600. Dorian's actual travel costs were as follows:

| | |
|---|---:|
| Hotels | $3,200 |
| Meals While Travelling | 1,800 |
| Airline Tickets | 1,500 |
| Total | $6,500 |

During 2019, Dorian received the following gifts from his employer:

- A $400 gift certificate for merchandise at a local department store.
- A Christmas gift basket containing various gourmet items. This basket, which has a value of $325, was provided to all of the company's employees.

Dorian is required by his employer to maintain an office in his home. This home office uses 20 percent of the floor space in his home. The cost of the house, excluding the land, was $426,000. It was purchased in 2018 and, during 2019, costs were as follows:

| | |
|---|---:|
| Mortgage Interest | $ 6,200 |
| Property Taxes | 4,320 |
| Utilities And Maintenance | 1,850 |
| Insurance | 1,140 |
| Total | $13,510 |

***Business Information***

Because of his interest in antiques, Dorian operates a small, unincorporated retail business. The business uses a taxation year that ends on December 31, and during the year ending December 31, 2019, the business produced an accounting net income of $71,500. As his business is not incorporated, this figure does not include a deduction for income taxes. Other relevant information with respect to his business is as follows:

1. At the beginning of 2019, Dorian owned depreciable assets that were used in the business and their UCC balances are as follows:

| | Class 1 | Class 8 | Class 10 |
|---|---:|---:|---:|
| January 1, 2019 UCC | $351,000 | $63,400 | $25,000 |

   The Class 1 building was acquired in 2015, is used exclusively for retail purposes and is the only building in Class 1.

   In March, 2019, Class 8 assets with a cost of $18,000 were sold for $11,300. They were replaced by Class 8 assets with a cost of $21,100.

2. During 2019, the business spent $12,600 landscaping its premises. For accounting purposes, this amount is being amortized over 10 years on a straight line basis.
3. The Net Income figure is after the deduction of Amortization Expense of $31,200 and $11,000 in meals and entertainment with clients of the business. The Amortization Expense includes the amortization of the landscaping costs.
4. Dorian intends to deduct the maximum amount of CCA for the year.

**Required:** For the taxation year ending December 31, 2019, calculate Dorian's:

A. minimum Net Income For Tax Purposes.

B. minimum Taxable Income.

C. Federal Tax Payable.

Ignore GST/HST/PST considerations in your solution.

### Assignment Problem Six - 15
### (Comprehensive Case Covering Chapters 1 to 6)

#### Personal Information

Hillary Hawk has been divorced for some time and has sole custody of her two children, Mark and Mandy. Mark is 13 and Mandy turned 18 on July 1, 2019. Because her former husband has disappeared, she receives no child support or spousal support.

Mark is in high school and has no income of his own.

During 2019, her daughter Mandy was enrolled part-time at a local college. Hillary agreed to pay her tuition of $1,800 as long as Mandy transferred the related credit to her (Hillary). Mandy's 2019 Net Income For Tax Purposes is $6,300.

During the year, Hillary paid $8,000 for orthodontic work (braces) for Mark. She was reimbursed 50 percent of the amount through her employer's dental and health plan.

During 2019, Hillary made $2,300 of contributions to registered charities.

#### Employment Information

Hillary is a sales representative for Bronze Age Inc. (BA), a Canadian public company that specializes in the marketing of metal sculptures.

Hillary's employment contract specifies a base salary of $100,000, plus a commission of 2 percent of her annual cash sales. For 2019, the applicable amount of cash sales is $4,800,000.

For 2019, Hillary's employer withheld the following amounts from her salary:

| | |
|---|---|
| RPP Contributions | 6,200 |
| CPP Contributions | 2,749 |
| EI Premiums | 860 |
| Premiums For BA's Dental And Health Plan* | 3,200 |
| Professional Association Dues | 2,700 |
| Federal Income Tax | 39,400 |

* The plan is funded 50/50 by the employees and the employer.

Hillary is covered by BA's group term life insurance. Her coverage is equal to her annual base salary ($100,000 for 2019). BA pays a premium to the insurance company of $3 for every $1,000 of coverage.

Because of her outstanding sales record, Hillary received the Salesperson Of The Year Award. This award provided her with a cash payment of $1,000, plus an iPad Pro which cost BA $1,700.

During 2019, BA provides Hillary with an automobile that it leases for $650 per month. The automobile was available for her personal use throughout 2019. During this period, she drove the car 42,000 kilometers, only 4,000 of which related to personal matters. While BA pays $2,800 to provide Hillary with insurance on the vehicle, they do not pay any of the other operating expenses.

Hillary is responsible for her salesperson expenses (including the automobile operating expenses). During 2019 she incurred the following:

| | |
|---|---|
| Total Automobile Expenses (Excluding Insurance) | $8,500 |
| Meals And Entertainment With Clients | 5,800 |
| Hotels | 3,200 |

Hillary meets all of the conditions of ITA 8(1)(f) of the *Income Tax Act* (deductible salesperson expenses).

Last year, in July of 2018, Hillary's employer transferred her from the Kelowna office to the Vancouver office. All of her moving expenses were paid for by her employer. Because she needed to sell her Kelowna home quickly, a $38,000 loss was incurred on the sale. While her employer agreed to compensate Hillary for $25,000 of this loss, the payment was not received until February, 2019.

In April of 2018, Hillary's employer granted her the right to purchase up to 3,000 shares of BA for $27 per share under the employee stock option plan. At the time the option was granted, the shares were trading for $25. On March 1, 2019, when the shares were trading at $29 per share, she exercises all of these options. In December, 2019, she sold 2,000 shares of the acquired option shares for $33 per share.

In order to purchase the 3,000 shares, Hillary negotiated an interest free loan from her employer for the purchase price. The loan was received on March 1, 2019. Joan repaid the loan on December 31, 2019.

***Business Information***

In addition to her employment income, Hillary has income from an unincorporated business that advises individuals and corporations on purchases of various types of art for their homes and offices. Hillary uses 15 percent of the space in her Vancouver home for this business. Her 2019 household expenses include the following:

| | |
|---|---|
| All Utilities | $4,200 |
| Property Taxes | 6,500 |
| Maintenance | 2,400 |
| Home Internet Service | 900 |
| Insurance On Her Home | 2,100 |
| Mortgage Interest | 11,500 |

Hillary estimates only 10 percent of the internet use was for her business because her children stream a lot of entertainment on a variety of devices. She does not claim CCA on her home as she realizes that if she did, this would result in future recapture and capital gains implications.

On January 1, 2019, the business had the following UCC balances:

| | |
|---|---|
| Class 8 | $ 6,912 |
| Class 10.1 | 12,495 |

During 2019, she acquires additional Class 8 assets at a cost of $12,000. These assets replaced assets with a capital cost of $9,000. The replaced assets were sold for $1,200.

The Class 10.1 asset had cost $36,000. It was sold during 2019 for $16,000 and replaced with a new vehicle with a cost of $41,000. Both vehicles were used solely for her business. She uses the employer provided automobile for the little bit of personal travel that she does do.

For 2019, the net income of this business, determined using generally accepted accounting principles, was $63,000. Included in this figure were the following:

| | |
|---|---|
| Amortization Expense | $5,200 |
| Business Meals And Entertainment | 6,400 |
| Work Space In The Home Costs* | Nil |

*Hillary did not believe that these costs could be deducted under generally accepted accounting principles.

**Required:**
For the 2019 taxation year, calculate Hillary's minimum:

1. Net Income For Tax Purposes,
2. Taxable Income,
3. Federal Tax Liability.

In determining these amounts, assume the prescribed rate during all four quarters of 2019 is 2 percent. Ignore GST, PST and HST considerations.

# CHAPTER 7

# Income From Property

## Introduction

7-1. Subdivision b of Division B of the *Income Tax Act* provides simultaneous coverage of both income from business and income from property. The parts of this subdivision relating to business income are covered in Chapter 6, and many of these provisions are equally applicable to income from property. However, there are sufficient features that are unique to income from property that separate coverage of this subject is warranted and is provided in this Chapter. We have also included coverage of some of the basic issues related to interest deductibility in this Chapter.

## Property Income: General Concept

7-2. Income from property is thought of as the return on invested capital in situations where little or no effort is required by the investor to produce the return. Falling into this category would be rents, interest, dividends, and royalties. In terms of tax legislation, capital gains are not treated as a component of property income, even in cases where they arise on investments being held to produce property income (e.g., capital gains on dividend paying shares). This point is made clear in ITA 9(3) which states that "income from a property does not include any capital gain ...".

7-3. In cases where a great deal of time and effort is directed at producing interest or rents, such returns can be considered business income. For example, the rents earned by a company that owns a number of shopping centers would be treated as a component of business income. As explained in Chapter 12, this is an important distinction for corporations since business income qualifies for the small business deduction, while property income generally does not.

7-4. The primary characteristic that distinguishes property income from business income is the lack of effort directed towards its production. However, in some circumstances, other factors must also be considered. Some examples of why the correct classification is important are as follows:

- When some types of property income are being earned, the deduction of capital cost allowance (CCA) cannot be used to create or increase a net loss for the period.

- When property income is being earned by individuals, there is no requirement for a pro rata CCA reduction to reflect a short fiscal period.

- When property income is being earned, the income attribution rules (see Chapter 9) are applicable. This is not the case when business income is being earned.
- Certain expenses can be deducted against business income, but not property income. These include travel costs and convention expenses. In contrast, for individuals, there is a deduction for foreign taxes on property income in excess of 15 percent that is not available against foreign business income.

7-5. A further general point is that the cost of obtaining investment counseling is generally deductible against property income. Although the cost of having a safety deposit box to hold investments was once deductible, it is no longer deductible.

# Interest As A Deduction

## The Problem

7-6. There are differing views on the extent to which interest costs should be considered a deductible item for various classes of taxpayers. At one extreme, we have the situation that once existed in the U.S where it was possible for individuals to deduct all interest costs, without regard to the purpose of the borrowing. In contrast, there are other tax regimes where the deductibility of interest is restricted to certain, very specific types of transactions.

7-7. From a conceptual point of view, it can be argued that interest should only be deductible to the extent it is paid on funds that are borrowed to produce income that is fully taxable in the period in which the interest is paid. The application of this concept would clearly disallow the current deduction of interest when it relates to:

- the acquisition of items for personal consumption;
- the acquisition of assets which produce income that is only partially taxed (e.g., capital gains); or
- the acquisition of assets which produce income that will not be taxed until a subsequent taxation year (e.g., gains on investments in land).

7-8. To some extent, the preceding view is incorporated into the current legislation. The real problem, however, is that there are such a multitude of provisions related to the special treatment of certain types of income and to the deferral of income, that the application of this fairly straightforward concept becomes very complex.

7-9. As is noted in Chapter 6, the general provision for the deduction of interest is found in ITA 20(1)(c). This provision provides for the deduction of interest only if it relates to the production of business or property income. This means that, in general, interest cannot be deducted if it relates only to such other sources of income as employment income or capital gains. Note, however, that if this production of income criteria is met, the deduction is available to all types of taxpayers, including corporations, individuals, and trusts.

7-10. As a final general point here, you will recall that when an employee receives an interest free or low interest loan from an employer, imputed interest on the loan will be included in employment income as a taxable benefit. Under ITA 80.5, this imputed interest is deemed to be interest paid and, if the loan from the employer is used to produce business or property income, the amount that was included in the employee's income will be deductible under ITA 20(1)(c).

## IT Folio S3-F6-C1 "Interest Deductibility"

7-11. The rules for interest deductibility are largely found in IT Folio S3-F6-C1, *Interest Deductibility*. We will give fairly detailed attention to the content of this Folio in the material which follows.

## What Is Interest?

7-12. In order to be considered interest for tax purposes, IT Folio S3-F6-C1 indicates that the amount has to satisfy three criteria:

- It must be calculated on a day-to-day accrual basis.
- It must be calculated on a principal sum or the right to a principal sum.
- It must be compensation for the use of the principal sum or the right to the principal sum.

7-13. IT Folio S3-F6-C1 notes that, in general, participating payments (e.g., payments based on earnings) are not considered to be interest. However, if there is an upper limit on the applicable rate and that upper limit reflects prevailing market conditions, such payments may qualify as interest. Payments that are contingent on some future event would not generally be considered interest.

7-14. IT Folio S3-F6-C1 also notes that in some situations where a contract does not explicitly identify any amount as interest, amounts that can reasonably be regarded as interest will be deemed to be interest for income and expense purposes.

## Legislation

7-15. The basic provision for interest deductibility is found in ITA 20(1)(c). It indicates that an amount paid or payable in a year can be deducted if:

- it is interest on borrowed money used for the purpose of earning income from a business or property, other than exempt income; or
- it is interest on an amount payable for property acquired for the purpose of gaining or producing income, other than exempt income.

7-16. The basic idea here is that you can deduct interest if it is paid to earn non-exempt income. While this basic concept sounds very simple and straightforward, its application has proved to be extremely contentious. Many issues related to this concept have found their way into all levels of the Canadian court system, including a number of cases that have been heard at the Supreme Court level. Of these hundreds of court cases, some have involved substantial sums of money. IT Folio S3-F6-C1 was issued to provide assistance in dealing with the issues that have arisen over recent years.

## Borrowed To Produce Income

7-17. For money to be borrowed, a relationship between a borrower and a lender is required. There is a distinction between "borrowed money" and "an amount payable for property". However, in either situation, interest can be deductible and need not concern us in the context of this introductory text.

7-18. The more complex issue here is whether the interest relates to the production of income. The relevant test is whether, considering all the circumstances, the taxpayer had a reasonable expectation of income from the investments that were made with the borrowed funds. Note that there does not have to be a profit generated. This requirement simply means that as a result of the borrowing, there will be an amount that would be included in the determination of the taxpayer's Net Income For Tax Purposes, should the investment prove to be profitable.

## Direct Or Indirect Use

### *The Singleton And Ludco Cases*

7-19. A number of court cases have dealt with this issue, thereby establishing the principle that it is the direct use of the funds that establishes deductibility. This was, perhaps, most clearly established in the Singleton case (The Queen vs. Singleton; 2001 DTC 5533). This case involved a lawyer who made a withdrawal of funds from his capital account in the law firm where he worked. These funds were used to purchase a residence for his personal use. Immediately after, he borrowed sufficient funds to replace the capital balance that he had withdrawn from his firm and then proceeded to deduct the interest on these borrowings. Mr. Singleton argued that the money borrowed was directly used to invest in the partnership and, because this was an income producing purpose, the interest should be deductible.

7-20. The CRA denied this deduction on the basis that the real purpose of the borrowings was to finance the purchase of his residence, a view that was supported by the Tax Court of Canada. However, both the Federal Court of Appeal and the Supreme Court of Canada disagreed. In making this decision, the Supreme Court noted that, in the absence of a sham or a specific provision in the *Act* to the contrary, the economic realities of a transaction cannot be used to recharacterize a clearly established legal relationship.

7-21. The facts in the Ludco case (Ludco Enterprises Ltd. vs. The Queen; 2001 DTC 5505) involved the Company borrowing $7.5 million which was used to finance investments in two offshore companies. During the period that these investments were held, Ludco paid $6 million in interest on the borrowings and received $600,000 in dividends on the shares held. When the shares were ultimately redeemed, Ludco realized a $9.2 million capital gain.

7-22. The CRA denied the deduction of the interest on the grounds that the shares were acquired for the purpose of earning a capital gain, not for the purpose of earning business or property income. While the Federal Court of Appeal agreed with the CRA, the Supreme Court of Canada did not. They concluded that an investment can have multiple purposes and, as long as one of these was the earning of property income, the condition that borrowing must be for the purpose of earning income was satisfied. That provision does not require either a quantitative determination of income or a judicial assessment of the sufficiency of income in order to satisfy its requirements.

### Examples Of Direct Use Approach

7-23. IT Folio S3-F6-C1 provides several examples designed to illustrate the implementation of the direct use concept:

> **EXAMPLE 1 - Restructured Borrowings** Ms. A owns 1,000 shares of X Corporation, a corporation listed on the TSX. Ms. A also owns a personal use condominium that was financed with borrowed money. At this point, the direct use of the borrowed money was to acquire the condominium. Ms. A may choose to sell the 1,000 shares of X Corp., use the proceeds to pay down the mortgage, and subsequently obtain additional borrowed money to acquire another 1,000 shares of X Corp. At this point, the additional borrowed money is directly used to acquire 1,000 shares of X Corporation.
>
> **EXAMPLE 2 - Cash Damming** Cash damming is a procedure that involves segregating funds received from borrowed money from those received from other sources. B Corporation establishes two accounts with its financial institution. The only deposits to account X are those consisting of borrowed money. All other deposits (e.g., funds from operations) are made to account Y. B Corporation ensures that all payments from account X are for expenditures for which the conditions for interest deductibility are clearly met (e.g., capital expenditures). Account Y is used for other expenditures.
>
> Examples 3 to 6 are examples of tracing/linking borrowed money to its current use.
>
> **EXAMPLE 3 - Replacement With Single Property** Mr. A acquired income producing Property X with $100,000 of borrowed money, the entire amount of which remains outstanding. Mr. A subsequently disposed of Property X for $100,000 and used the proceeds of disposition to acquire income producing Property Y for $100,000. As the current use of the borrowed money is with respect to Property Y, the interest on the original loan would continue to be deductible.
>
> **EXAMPLE 4 - Replacement With Multiple Properties** Ms. A acquired income producing Property X with $100,000 of borrowed money, the entire amount of which remains outstanding. Ms. A subsequently disposed of Property X for $100,000 and used the proceeds of disposition to acquire income producing Property Y for $60,000 and income producing Property Z for $40,000. The borrowed money would be allocated 60 percent ($60,000/$100,000) to Property Y and 40 percent to Property Z. The interest on the original loan would continue to be deductible.

**EXAMPLE 5 - Flexible Approach To Linking** B Corp. acquired income producing Property X with $1,000,000 of borrowed money, the entire amount of which remains outstanding. B Corp. subsequently disposed of Property X for $1,500,000 and used the proceeds of disposition to acquire income producing Property Y for $1,200,000 and income producing Property Z for $300,000. B Corp. has flexibility in choosing the allocation of the current use of the borrowed money. Since the value of Property Y exceeds the $1,000,000 amount of the borrowings, it could be entirely allocated to Property Y. Alternatively, B Corp. could choose to allocate $300,000 of the current use of the borrowed money to Property Z, allocating the remaining $700,000 to Property Y. In either case, interest on the $1,000,000 would continue to be deductible.

**EXAMPLE 6 - Replacement Properties Less Than Borrowed Money** Assume the same facts as in Example 5, except that Property X was sold for $800,000. The proceeds of disposition were used to acquire income producing Property Y for $600,000 and income producing Property Z for $200,000. The current use of the borrowed money would have to be pro-rated between the two new properties, with 75 percent ($600,000/$800,000) to Property Y and 25 percent ($200,000/$800,000) to Property Z. Interest on the $1,000,000 would continue to be deductible.

**EXAMPLE 7 - Disappearing Source Rule** Mr. A borrows $100,000 to purchase an income-earning property. The entire amount of the loan remains outstanding and interest on the loan is deductible. Mr. A subsequently disposes of the property for its fair market value, now down to $60,000. He uses the $60,000 to reduce the outstanding loan. Under ITA 20.1, the remaining loan balance of $40,000 will be deemed to be used for the purpose of earning income and interest on this remaining amount will continue to be deductible.

### *Exceptions To The Direct Use Approach*

7-24. While direct use is the general rule, IT Folio S3-F6-C1 does indicate, however, that there are exceptions to this rule. These exceptions include:

**Filling The Hole** IT Folio S3-F6-C1 uses the term "filling the hole" to describe situations where money is borrowed to pay dividends, to redeem shares, or to return capital of a corporation or partnership. The basic idea here is that the new debt replaces other forms of capital that were invested in income producing assets. In the case of dividends, this seems to be a bit of a stretch. However, the argument is that the borrowings replace the retained earnings that are being distributed in the form of dividends.

**Interest-Free Loans** In general, interest on money borrowed to make interest-free loans would not be deductible as the purpose of the borrowing is not to produce income. However, it can be argued that an interest-free loan to a wholly owned subsidiary has been made with a view to helping the subsidiary produce income which can ultimately be used to pay dividends. IT Folio S3-F6-C1 indicates that the interest on borrowings to make interest-free loans of this type would be deductible.

A further exception is when money is borrowed to make interest-free loans to employees. The argument here is that the interest-free loan is a form of employee compensation, the purpose of which is to encourage the employees to help the employer produce income.

### *Interest Deductibility On Investments In Common Shares*

7-25. IT Folio S3-F6-C1 deals with a number of other issues associated with interest deductibility. Its guidance on dealing with premium and discount on the issuance of debt is discussed later in this Chapter. Most of the other issues covered are sufficiently specialized that they go beyond the scope of this text. There is, however, one other issue here of general importance.

7-26. This is the question of whether interest on funds used to invest in common shares should be considered deductible. The problem is that common shares generally do not carry a

stated interest or dividend rate and, in some cases, simply do not pay dividends, either currently or for the foreseeable future. While capital gains may ultimately make such investments profitable, there are many cases where investments in common shares could be viewed as not producing property income.

7-27. Fortunately, IT Folio S3-F6-C1 indicates that in most circumstances the CRA will consider interest on funds borrowed to invest in common shares to be deductible. This is on the basis of a reasonable expectation, at the time the shares are acquired, that the holder will at some time in the future receive dividends. They do, however, give an example of a situation where this expectation is not viable:

> **EXAMPLE** X Corp. is an investment vehicle designed to provide only a capital return to the investors in its common shares. The corporate policy with respect to X Corp. is that dividends will not be paid, that corporate earnings will be reinvested to increase the value of the shares and that shareholders are required to sell their shares to a third-party purchaser in a fixed number of years in order to realize their value. In this situation, it is not reasonable to expect income from such shareholdings and any interest expense on money borrowed to acquire X Corp. shares would not be deductible.

7-28. An example is also provided of a situation in which interest would be deductible:

> **EXAMPLE** Y Corp. is raising capital by issuing common shares. Its business plans indicate that its cash flow will be required to be reinvested for the foreseeable future. Y Corp. discloses to shareholders that dividends will only be paid when operational circumstances permit (that is, when cash flow exceeds requirements) or when it believes that shareholders could make better use of the cash. In this situation, the purpose of earning income test will generally be met and any interest on borrowed money used to acquire Y Corp. shares would be deductible.

**We suggest you work Self Study Problem Seven-1 at this point.**

## Discount And Premium On Long-Term Issued Debt

### *Economic Background*

7-29. When a debt security is issued with an interest rate below the current rate, investors will react by offering a price that is less than the maturity value of the security. Such securities are said to sell at a discount and, in economic terms, this discount generally represents an additional interest charge to be recognized over the life of the security.

7-30. For example, a 10 year bond with a maturity value of $100,000 and a 10 percent stated interest rate, would sell for $88,700 to investors expecting a 12 percent interest rate. The discount of $11,300 ($100,000 - $88,700) would then be added to interest expense at the rate of $1,130 per year for the ten year period. Note that, in order simplify the presentation of this material, we are using the straight-line amortization of discount and premium. This approach is acceptable under GAAP for private enterprises. However, under international accounting standards, the effective rate method must be used.

7-31. In a corresponding fashion, a debt security that offered an interest rate above that currently expected by investors would command a premium. Such a premium would then be treated as a reduction in interest expense over the remaining life of the debt security.

7-32. The procedures described in the preceding Paragraph are, of course, well known to anyone familiar with normal accounting procedures. Surprisingly, the tax rules for dealing with bond premium and discount do not reflect these well established principles.

7-33. The required tax procedures are completely different from the accounting procedures, are inconsistent in the treatment of premium and discount, and have no conceptual basis of support. Despite this, IT Folio S3-F6-C1, *Interest Deductibility,* makes it clear that these somewhat bizarre procedures reflect the intent of the government.

### Tax Procedures - Issuers Of Discount Bonds

7-34. From the point of view of the issuer of a discount bond, the tax deductible amount of interest will be based on the stated, or coupon, rate without consideration of the difference between the proceeds received from the sale of the bonds and the larger amount that must be paid when the bonds mature. This excess will be treated as a loss on the retirement of the debt (i.e., a liability is being extinguished by paying more than its carrying value for tax purposes). You may recall from Chapter 6 that, under ITA 20(1)(f), this loss will be considered a fully deductible amount, provided:

- the bonds are issued for not less than 97 percent of their maturity value; and
- the effective yield on the bonds is not more than 4/3 of the stated, or coupon, rate.

7-35. If these conditions are not met, only one-half of the loss will be deductible. This, in effect, treats the loss in the same manner as a capital loss. It would appear that the goal here is to prevent the use of deep discount bonds which, because of the failure of tax legislation to deal appropriately with bond discount, results in the investor having a part of his interest income being converted to a capital gain. A more logical solution to this problem would be to revise the relevant tax legislation to better reflect the economic substance of bond discount.

## Exercise Seven - 1

**Subject:** Discount Bonds

On January 1, 2019, Moreau Ltd. issues bonds with a maturity value of $1,000,000 and a maturity date of December 31, 2021. The bonds pay interest on December 31 of each year at an annual coupon rate of 4 percent. They are sold for proceeds of $985,000 for an effective yield of 4.6 percent. The maturity amount is paid on December 31, 2021. What are the tax consequences related to this bond issue for Moreau Ltd. in each of the years 2019, 2020, and 2021? How would these tax consequences differ from the information included in Moreau's GAAP based financial statements? Moreau uses the straight-line method to amortize the discount on the bonds for accounting purposes.

**SOLUTION available in print and online Study Guide.**

### Tax Procedures - Issuers Of Premium Bonds

7-36. IT Folio S3-F6-C1 makes it clear that premium situations are not treated in a manner that is analogous with the treatment of discounts. IT Folio S3-F6-C1 indicates that, depending on the situation, three different possible approaches may be used by debt issuers for dealing with bond premium. These alternatives can be described as follows:

**Money Lenders** IT Folio S3-F6-C1 indicates that, in situations where the borrowed money constitutes stock-in-trade for a taxpayer that is in the financing business, premium on the debt must be taken into income immediately. IT Folio S3-F6-C1 also makes it clear that this amount would not be given capital gains treatment and, as a consequence, would be 100 percent taxable. Given this treatment of the premium, the deductible amount of interest would be equal to the stated, or coupon, rate.

**Other Taxpayers** In what constitutes something of a windfall for taxpayers issuing debt at a premium, IT Folio S3-F6-C1 indicates that the amount of premium received at the time of issue would be considered a non-taxable capital receipt. While IT Folio S3-F6-C1 is not clear on this issue, it appears that there will be no further tax consequences related to the premium when the bonds are retired. Unlike the case with bond discount, where there is a specific ITA Paragraph which provides for the deduction of this amount at the maturity of the bonds, there is no corresponding provision that requires the premium to be treated as a gain when the bonds are retired.

**Deliberate Creation Of A Premium** IT Folio S3-F6-C1 introduces a third approach based on the very fuzzy concept of a "premium which arises because the debt was deliberately priced to give rise to a premium". There appears to be concern here that an enterprise might create additional tax deductions by setting an unrealistically high rate of interest on the issuance of debt. While it is not clear how "unrealistically high" will be measured, the tax consequence is that the contractual amount of interest paid will be viewed as unreasonable and will be reduced to a reasonable amount over the life of the debt. As this appears to be consistent with the premium amortization approach used in accounting, it seems the CRA's position is that only in unreasonable circumstances is it appropriate to use a reasonable approach to dealing with bond premium.

7-37. With most conventional debt issuances, the second approach would be applicable. It is interesting to note that, in comparison with the applicable accounting procedures, this approach produces a larger interest deduction and this enhanced deduction is not offset by a gain when the bonds are retired. This permanent difference between accounting and tax income should make taxpayers who issue premium bonds very happy.

**Exercise Seven - 2**

**Subject:** Premium Bonds

On January 1 of the current year, Cannon Inc. issues 10 year bonds payable with a maturity value of $1,000,000. The bonds have a coupon rate of 18 percent, pay interest on January 1 of each year, and are sold for $1,400,000. The Company has a December 31 year end. Determine the current year tax consequences under each of the following assumptions:

- Cannon is in the business of lending money.
- Cannon is not in the business of lending money and did not make a deliberate effort to create a premium on the issuance of the bonds.
- Cannon is not in the business of lending money and made a deliberate effort to create a premium on the issuance of the bonds.

**SOLUTION available in print and online Study Guide.**

# Interest Income

## General Provision

7-38. ITA 12(1) lists inclusions in business and property income. Paragraph (c) of this Subsection is as follows:

**Interest** ... any amount received or receivable by the taxpayer in the year (depending on the method regularly followed by the taxpayer in computing the taxpayer's income) as, on account of, in lieu of payment of or in satisfaction of, interest to the extent that the interest was not included in computing the taxpayer's income for a preceding taxation year.

7-39. The wording of ITA 12(1)(c) suggests that taxpayers can use the cash basis to recognize interest income (amounts received or receivable). This is not the case. ITA 12(3) and 12(4) require the use of an accrual approach by all taxpayers. As is discussed in the following material, the accrual approach used by individuals differs from that used by corporations and partnerships.

## Corporations And Partnerships - Full Accrual Method

7-40. ITA 12(3) requires that corporations, partnerships, and some trusts use accrual accounting. The concept of accrual accounting that is applied to these taxpayers is the conventional one in which interest income is recorded as a direct function of the passage of time. IT-396R indicates that this calculation will generally be based on the number of days a

principal amount is outstanding.

**EXAMPLE** A corporation acquires a $5,000 debt instrument on August 15th of the current year. The instrument pays interest at an annual rate of 8 percent.

**ANALYSIS** Interest for the current year would be calculated as follows:

$$[(\$5,000)(8\%)(139 \div 365)] = \$152.33$$

7-41. For corporations and partnerships, interest income for tax purposes is, generally speaking, identical to that required under the application of generally accepted accounting principles. However, as will be explained later in this Chapter, an exception to this is interest income on bonds that have been purchased at a premium or a discount.

## Individuals - Modified Accrual Method

7-42. While ITA 12(3) requires conventional accrual accounting for corporations and partnerships, ITA 12(4) provides for a less familiar version of this concept for individuals. Under this modified version of accrual accounting, interest is not accrued on a continuous basis. Rather, ITA 12(4) requires the accrual of interest on each anniversary date of an investment contract.

7-43. ITA 12(11) defines "investment contracts" to include most debt securities and "anniversary date" to be that date that is one year after the day before the date of issue of the security, and every successive one year interval. This would mean that, for a five year contract issued on July 1, 2019, the anniversary dates would be June 30 of each of the five years 2020 through 2024. If the holder of the investment contract disposes of it prior to its maturity, the disposal date is also considered to be an anniversary date from the point of view of that particular taxpayer.

7-44. To the extent that the income accrued on the anniversary date has not been previously included in income, it must then be included in the individual's income, regardless of whether the amount has been received or is receivable.

**EXAMPLE** An investment contract with a maturity value of $100,000 and an annual interest rate of 10 percent is issued on July 1, 2019. The $100,000 maturity amount is due on June 30, 2024. An interest payment for the first 2.5 years of interest ($25,000) is due on December 31, 2021. The remaining interest ($25,000) is due with the principal payment on June 30, 2024. The contract is purchased by an individual at the time that it is issued.

**ANALYSIS** As no interest has been received in calendar year 2019 and no anniversary date has occurred during the year, no interest would have to be included in the individual's tax return for that year. As compared to the use of the full accrual method, this provides a one year deferral of $5,000 [(10%)($100,000)(1/2)] of interest.

Annual interest of $10,000 would have to be accrued on the first two anniversary dates of the contract, June 30, 2020 and June 30, 2021. This means that $10,000 would be included in Net Income For Tax Purposes for each of these two years. When the $25,000 payment is received on December 31, 2021, an additional $5,000 would be subject to taxation for that year because it has been received, and not previously accrued. This results in taxation of $15,000 in 2021. At this point, the cumulative results are identical to those that would result from the application of the full accrual approach.

For 2022, the June 30, 2022 anniversary date would require the accrual of $10,000. However, as $5,000 of this amount was already included in income during 2021, only $5,000 of this amount would be subject to taxation in 2022. There would be a further accrual of $10,000 on the anniversary date in 2023. In 2024, an interest payment of $25,000 will be received. As $15,000 ($5,000 + $10,000) of the amount received has been included in 2022 and 2023 income, the total for 2024 will be $10,000 ($25,000 - $15,000).

Under the modified accrual method, the total interest of $50,000 would be recognized as follows:

| | |
|---|---|
| 2019 | $ Nil |
| 2020 | 10,000 |
| 2021 | 15,000 |
| 2022 | 5,000 |
| 2023 | 10,000 |
| 2024 | 10,000 |
| Total | $50,000 |

7-45. Note that the anniversary date is established by the date on which the investment contract is issued. It is not influenced by the date on which the individual investor acquires the contract. If this contract had been sold to another individual, for example on January 1, 2023, the required interest accruals would have been the same for the seller. There would, however, be an adjustment for accrued or recognized interest at transfer as discussed in Paragraph 7-48.

## Exercise Seven - 3

**Subject:** Annual Accrual Rules

On October 1, 2019, Ms. Diane Dumont acquires a newly issued debt instrument with a maturity value of $60,000. It matures on September 30, 2025 and pays interest at an annual rate of 8 percent. Payment for the first three and one-quarter years of interest is due on December 31, 2022, with interest for the remaining two and three-quarters years payable on the maturity date. What amount of interest will Ms. Dumont have to include in her tax returns for each of the years 2019 through 2025?

**SOLUTION available in print and online Study Guide.**

## Discount And Premium On Long-Term Debt Holdings

7-46. Tax legislation takes the view that the taxable amount of interest is based on the accrual of the stated, or coupon, rate, without consideration of the fact that, in the case of bonds sold at a discount or premium, the investor will receive an amount at maturity that is larger or smaller than the amount that was paid for the bonds. Because tax procedures do not provide for the usual amortization of this discount or premium, it will be treated as a gain or loss at maturity by the investor.

7-47. If the bonds are acquired at a discount, the additional amount that will be received at maturity (the discount) will be treated as a capital gain, only one-half of which will be taxable. In similar fashion, if the bonds are acquired at a premium, the receipt of just the face value at maturity will result in the premium being treated as a capital loss, only one-half of which will be deductible.

## Accrued Interest At Transfer

7-48. Publicly traded debt securities are bought and sold on a day-to-day basis, without regard to the specific date on which interest payments are due. To accommodate this situation, accrued interest from the date of the last interest payment date will be added to the purchase price of the security.

7-49. Consider, for example, a 10 percent coupon, $1,000 maturity value bond, with semi-annual interest payments of $50 on June 30 and December 31 of each year. If we assume that the market value of the bond is equal to its maturity value and it is purchased on October 1, 2019, the price would be $1,025, including $25 [($50)(92/184 days)] of interest for the period from July 1, 2019 through October 1, 2019.

7-50. In the absence of a special provision dealing with this situation, the $25 would have to be included in the income of the purchaser when it is received as part of the $50 December 31, 2019 interest payment. Further, the extra $25 received by the seller would receive favourable treatment as a capital gain. To prevent this result, ITA 20(14) indicates that the seller must include the accrued interest in income and the purchaser can deduct a corresponding amount from the interest received on the bonds.

**Exercise Seven - 4**

**Subject:** Accrued Interest At Transfer

On May 1, 2019, Mr. Milford Lay purchases bonds with a maturity value of $50,000 at par. These bonds pay semi-annual interest of $3,000 on June 30 and December 31 of each year. He purchases the bonds for $51,989, including interest accrued to the purchase date. He holds the bonds for the remainder of the year, receiving both the June 30 and December 31 interest payments. What amount of interest will be included in Mr. Lay's 2019 tax return?

**SOLUTION available in print and online Study Guide.**

# Payments Based On Production Or Use (Royalties)

7-51. The relevant *Income Tax Act* Paragraph here reads as follows:

**ITA 12(1)(g)** Payments based on production or use — any amount received by the taxpayer in the year that was dependent on the use of or production from property whether or not that amount was an instalment of the sale price of the property, except that an instalment of the sale price of agricultural land is not included by virtue of this paragraph.

7-52. While ITA 12(1)(g), by referring only to amounts received, suggests the use of cash basis revenue recognition, this has limited application. ITA 12(2.01) indicates that ITA 12(1)(g) cannot be used to defer the inclusion of any item that would normally be included in the determination of business income. This would require the use of an accrual approach.

7-53. ITA 12(1)(g) also requires that, except in the case of agricultural land, payments that represent instalments on the sale price of the property must also be included if their payment is related to production or use. An example will serve to illustrate this provision:

**EXAMPLE** The owner of a mineral deposit sells the asset with the proceeds to be paid on the basis of $2 per ton of ore removed. The total amount to be paid is not fixed by the sales agreement.

**ANALYSIS** In this situation, the owner would have to include in income the full amount received in each subsequent year, even though a portion of the payment may be of a capital nature.

# Rental Income

## General Rules

7-54. Rental income is not specifically mentioned in the ITA Sections that deal with income from property. There is some merit in the view that rental receipts fall into the category of payments for production or use. However, rents are generally payable without regard to whether or not the property is used and, as a consequence, this view may not be appropriate. In any case, it is clear that rental receipts must be included in income and, given this fact, income from property would appear to be the most logical classification.

7-55. With respect to the recognition methods to be used for rental income, the CRA's Guide, "Rental Income" (T4036) provides the following guidance:

> In most cases, you calculate your rental income using the accrual method. With this method, you:
>
> - include rents in income for the year in which they are due, whether or not you receive them in that year; and
> - deduct your expenses in the year you incur them, no matter when you pay them.
>
> However, if you have practically no amounts receivable and no expenses outstanding at the end of the year, you can use the cash method. With this method, you:
>
> - include rents in income in the year you receive them; and
> - deduct expenses in the year you pay them.
>
> You can use the cash method only if your net rental income or loss would be practically the same if you were using the accrual method.

7-56. Once the rental revenues are included in income, a variety of expenses become deductible against them. These would include utilities (such as heat, electricity and water), repairs, maintenance, interest, insurance, property taxes, management fees, and fees to rental agents for locating tenants. CCA can also be deducted. However, as discussed in the next section, this deduction is subject to several special rules.

## Capital Cost Allowances

### *General Rules*

7-57. As noted, CCA on rental properties can be claimed. In the year of acquisition, rental properties are eligible assets for the Accelerated Investment Incentive (AccII) provisions (see Chapter 5). For individuals, the calendar year is considered the fiscal year for property income purposes. As a consequence, there is no adjustment for a short fiscal period in the year of acquisition.

7-58. Buildings acquired after 1987 will generally fall into Class 1, where they are eligible for CCA calculated on a declining balance basis at a rate of 4 percent. However, as was noted in Chapter 5, if:

- a new building is acquired after March 18, 2007;
- it is used more than 90 percent for non-residential activities by the taxpayer or a lessee; and
- it is allocated to a separate Class 1;

it will be eligible for the enhanced CCA rates that were discussed in Chapter 5. You may recall that if the usage is 90 percent or more for manufacturing and processing, the rate is 10 percent. If this test is not met, but the building is used 90 percent or more for non-residential activity, the rate is 6 percent.

7-59. As mentioned in Chapter 5, buildings acquired prior to 1988 were allocated to Class 3, where the rate was 5 percent. This rate is still available on buildings that were allocated to Class 3 prior to 1988.

7-60. Without regard to the CCA class to which a building is allocated, the rate is applied only to the cost of the building, exclusive of land. This means that usually, the total cost of a real property must be segregated into land and building components. The land, of course, is not eligible for CCA deductions.

### *Special Rules*

7-61. There are two special rules that apply to CCA calculations on rental properties. These rules, along with a brief explanation of the reason that each was introduced, are as follows:

**Separate CCA Classes** Each rental building that is acquired after 1971 at a cost of $50,000 or more must be placed in a separate class for calculating CCA, recapture, and terminal losses. In most real world situations, the amount of CCA that can be deducted on a rental property exceeds any decline in the value of the building. In fact, it is not uncommon for the value of such properties to increase over time. This means that, if an investor is required to account for each rental property as a separate item, a disposition is likely to result in recapture of CCA and an increase in Tax Payable.

In the absence of this special rule, all rental properties could be allocated to a single class. This would mean that the investor could avoid recapture for long periods of time by simply adding new properties to the class. This separate class rule prevents this from happening.

**Rental Property CCA Restriction** In general, taxpayers are not permitted to create or increase a net rental loss by claiming CCA on rental properties. For this purpose, rental income is the total rental income or loss from all properties owned by the taxpayer. This amount includes any recapture, as well as any terminal losses. The reason for this restriction is a desire to limit the use of rental losses for purposes of sheltering other types of income (e.g., applying rental losses against employment income).

The fact that CCA is the only restricted deduction is probably based on the fact that, unlike most depreciable assets, the value of many rental properties does not decline over time. This restriction does not apply to a corporation or a corporate partnership whose principal business throughout the year is the rental or sale of real property. There are similar restrictions on CCA with respect to leasing properties other than real estate.

7-62. Without question, these special rules make real estate less attractive as an investment. However, a number of advantages remain:

- taxation on a positive cash flow can be eliminated through the use of CCA;
- some part of the capital cost of an asset can be deducted despite the fact that real estate assets are generally not decreasing in value;
- increases in the value of the property are not taxed until the property is sold; and
- any gain resulting from a sale is taxed as a capital gain, only one-half of which is taxable.

7-63. These factors continue to make the tax features of investments in rental properties attractive to many individuals.

## Rental Income Example

7-64. An example will serve to illustrate the basic features involved in determining net rental income.

**EXAMPLE** On January 1, 2019, Mr. Bratton owns the following two rental properties:

- Property A was acquired in 1987 at a cost of $120,000, of which $20,000 was allocated to land. It has a UCC of $68,000.
- Property B was acquired in 2012 at a cost of $120,000, of which $30,000 is allocated to land. It has a UCC of $74,200. On August 28, 2019, Property B is sold for $155,000. At this time, the value of the land is unchanged at $30,000.

On December 1, 2019, Mr. Bratton acquires Property C at a cost of $200,000, of which $50,000 is allocated to land. The property is used exclusively for residential purposes.

Rents on all of the properties totaled $35,000 during 2019 and the cost of maintenance, property taxes, and mortgage interest totaled $45,400.

**Net Rental Income Calculation** The maximum available CCA, (taking the AccII provisions into consideration) on the three properties would be as follows:

- Property A (Class 3) = $3,400 [($68,000)(5%)]
- Property B (Class 1) = Nil (The property was sold during the year.)
- Property C (Class 1) = $9,000 [(150%)($150,000)(4%)]

Since a rental loss cannot be created by claiming CCA, the net rental income would be calculated as follows:

| | |
|---|---|
| Gross Rents | $35,000 |
| Recapture Of CCA On Property B ($90,000 - $74,200) | 15,800 |
| Expenses Other Than CCA | ( 45,400) |
| Rental Income Before CCA | $ 5,400 |
| CCA Class 1 (Limited) | ( 5,400) |
| Net Rental Income | Nil |

7-65. The CCA was taken on Class 1, the 4 percent class and it is limited to the net rental income before CCA of $5,400. This follows the general tax planning rule that suggests that, when less than the maximum allowable CCA is taken, the CCA that is deducted should be taken from the classes with the lowest rates. However, if there had been Class 8 rental assets such as appliances, it could have been more tax advantageous to take CCA on those assets first as there is little likelihood of recapture on them. Note that the taxable capital gain of $17,500 [(1/2)($125,000 - $90,000) + (1/2)($30,000 - $30,000)] on the sale of Property B is not part of the rental income or loss calculation.

### Exercise Seven - 5

**Subject**: Rental Income

Ms. Sheela Horne acquires a residential rental property in September, 2019 at a total cost of $185,000. Of this total, $42,000 can be allocated to the value of the land. She immediately spends $35,000 to make major improvements to the property. Rents for the year total $7,200, while rental expenses other than CCA total $5,100. This is the only rental property owned by Ms. Horne. Determine the maximum CCA that is available for 2019 and Ms. Horne's minimum net rental income for the year.

**SOLUTION available in print and online Study Guide.**

**We suggest you work Self Study Problem Seven-2 at this point.**

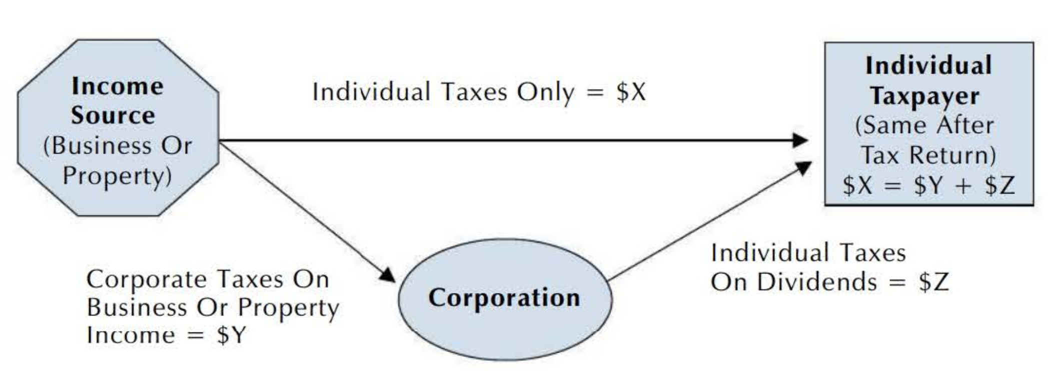
# Cash Dividends From Taxable Canadian Corporations

## The Concept Of Integration

7-66. While this concept will be given much more detailed attention in the Chapters dealing with corporate taxation, it is virtually impossible to understand the tax procedures associated with dividends received from taxable Canadian corporations without some elementary understanding of the concept of integration. It is fundamental, both to the procedures associated with the taxation of dividends, as well as to many other provisions related to the taxation of corporations.

7-67. An individual who owns an unincorporated business or, alternatively, holds investments that earn business or property income, can choose to transfer these assets to a

**Figure 7 - 1 The Concept Of Integration**




corporation. The various reasons for doing this will be given detailed consideration in Chapter 15. At this point, however, our concern is with the fact that, in making such a transfer, the taxpayer creates an additional taxable entity. As depicted in Figure 7-1, if the individual incorporates his source of business or property income, the corporation will be taxed on the resulting income. In addition, the individual will pay taxes on the dividends which the corporation will distribute from the corporation's after tax income.

7-68. As is also depicted in Figure 7-1, the goal of integration is to ensure that the use of a corporation does not alter the total amount of taxes that will be paid on a given stream of business or property income. Stated alternatively, the procedures associated with integration are directed at equating the total amount of taxes paid by an individual who does not incorporate an income source and pays taxes only at the individual level, with the amount of taxes that would be paid if the relevant assets were transferred to a corporation and taxed at both the corporate level and at the individual level on distribution of the after tax corporate income.

7-69. As we will find in the various chapters dealing with corporate taxation, there are a number of procedures associated with achieving this goal. However, from the point of view of individual taxpayers, the dividend gross up and tax credit procedures are the primary tools used in building a system which integrates corporate and individual tax amounts.

## Implementing Integration

### *Gross Up And Tax Credit Procedures*

7-70. The primary tool for implementing integration in the Canadian tax system involves two procedures:

> **Dividend Gross Up** Dividends received by individuals from taxable Canadian corporations are "grossed up" (i.e. increased) by an amount that reflects the tax paid at the corporate level. This grossed up amount then represents the amount of income that was received by the corporation prior to the payment of corporate taxes.
>
> **Dividend Tax Credit** After the individual calculates his regular Tax Payable on the grossed up amount, a credit is provided against this Tax Payable that makes up for the taxes that were paid at the corporate level.

7-71. A simple example will serve to illustrate how this works. Note that this is a conceptual example and does not reflect the rates that are built into the actual tax legislation.

> **EXAMPLE** Martin Tall has an income source which produces $100,000 of net business income each year. As Martin is in the 45 percent tax bracket, in the absence of a corporation he would pay taxes on this income of $45,000, resulting in after tax retention of $55,000. If he transfers this income source to a corporation, the corporation would pay taxes at a rate of 25 percent.

**NOTE** The gross up and credit rates used in this example are not the actual rates that currently apply to dividends received by individuals.

**ANALYSIS** Results at the corporate level would be as follows:

| | |
|---|---|
| Corporate Income Before Taxes | $100,000 |
| Corporate Taxes At 25 Percent | ( 25,000) |
| After Tax Income And Maximum Dividend Payable | $ 75,000 |

If the maximum dividend is paid by the corporation, a dividend gross up of one-third of dividends received [(1/3)($75,000) = $25,000] would be required to convert the dividend to the amount of pre-tax income received by the corporation:

| | |
|---|---|
| Dividends Received | $ 75,000 |
| Gross Up [(1/3)($75,000)] | 25,000 |
| Taxable Dividends = Pre-Tax Corporate Income | $100,000 |

Note that the required gross up of $25,000 is equal to the corporate taxes paid. Given this, if we use this amount as the dividend tax credit, it will serve to compensate Martin for the taxes that were paid at the corporate level. This is reflected in the following calculation of Martin's Tax Payable:

| | |
|---|---|
| Taxable Dividends (After Gross Up) | $100,000 |
| Martin's Tax Rate | 45% |
| Tax Payable Before Dividend Tax Credit | $ 45,000 |
| Dividend Tax Credit (Equal To Gross Up) | ( 25,000) |
| Martin's Tax Payable | $ 20,000 |

Based on the preceding calculation of Tax Payable, Martin's after tax retention would be calculated as follows:

| | |
|---|---|
| Dividends Received | $75,000 |
| Tax Payable | ( 20,000) |
| After Tax Retention - Use Of Corporation | $55,000 |

7-72. You will note that this is exactly the same $55,000 of after tax retention that would result from Martin receiving the $100,000 in income directly and being taxed on it at 45 percent. This means that, in this example, the gross up and tax credit procedures have produced perfect integration. That is, Martin has retained exactly the same amount of after tax income, without regard to whether the pre-tax income is received directly or, alternatively, is channeled through a corporation.

## The Problem

7-73. Thoughtful readers of the preceding example will recognize that the reason integration works is that the gross up and the resulting tax credit are exactly equal to the corporate taxes paid. For integration to work perfectly in the real world one of two sets of conditions would have to be present:

**Uniform Corporate Tax Rates** If every taxable Canadian corporation was taxed at the same rate, integration would work using a single gross up factor. For example, if all corporations were taxed at the 25 percent rate that was used in our illustration, a gross up of one-third would always produce perfect integration. While we haven't dealt with corporate taxation at this point, you are likely aware that there are literally dozens of different corporate tax rates in use. There are different rates for different types of income, as well as different corporate rates for each of the provinces and territories. This creates unavoidable imperfections in the integration system.

**Variable Gross Up Factors** It would still be possible to implement perfect integration in the presence of varying corporate tax rates if we had a system in which specific gross up factors were used for each corporation, with the factor being used reflecting the corporate tax rate applicable to that particular corporation. However, this would create many complications and has never been considered as a practical alternative.

### *The Solution - Eligible And Non-Eligible Dividends*

7-74. With the use of individual gross up factors not being a practical alternative, Canadian tax legislation uses two categories of dividends to deal with the problem of integration. These categories reflect the fact that, in general, Canadian public companies are subject to higher tax rates than those applicable to Canadian controlled private companies. The concepts of eligible and non-eligible dividends are based on this difference in rates.

**Eligible Dividends** For 2019, most of the income of Canadian public companies is taxed at combined federal/provincial tax rates that range from 26.5 to 31.0 percent. Because of the higher tax rates applicable to public companies, they are eligible for an enhanced gross up and tax credit procedure. As a result of this, most of the dividends paid by these companies are referred to as eligible dividends. This enhanced procedure is based on an assumed tax rate of 27.536 percent. You will note that this is within the range of the rates that are applicable to Canadian public companies. However, integration imperfections do still exist.

**Non-Eligible Dividends** For 2019, most of the income of Canadian controlled private corporations (CCPCs) is taxed at combined federal/provincial tax rates that range from 9 percent to 17 percent. Because their income is taxed at lower rates, they are not eligible for the enhanced gross up and tax credit procedure that is available on eligible dividends. Most dividends that are paid by CCPCs are referred to as non-eligible dividends. For 2019, this procedure is based on an assumed tax rate of 13.043 percent. As was the case with the assumed rate applicable to eligible dividends, this rate is within the range of rates applicable to CCPCs. However, integration imperfections do still exist for CCPCs as well.

### *A Note Of Caution*

7-75. The preceding material on gross up and tax credit procedures is greatly simplified and, given that we have not yet covered any material on corporate taxation, may be difficult to understand. However, we believe the preceding explanation of integration concepts must be understood in order to comprehend the material on dividends which follows.

## Gross Up And Tax Credit Procedures - Eligible Dividends

### *Definition Of Eligible Dividends*

7-76. ITA 89(1) defines "eligible dividends" as a taxable dividend that has been designated as such by the paying corporation. Prior to our more detailed coverage of corporate taxation, we will think of such designated dividends as those paid by Canadian public companies. While this is generally true, this simplification ignores the fact that:

- some dividends paid by Canadian public companies cannot be designated as eligible; and
- some dividends paid by Canadian controlled private companies can be designated as eligible.

### *Eligible Dividend Gross Up Procedure*

7-77. When an individual receives eligible dividends, the amount received is grossed up by 38 percent. This rate reflects an assumed corporate tax rate of 27.53623 percent. As illustrated in the following example, given this corporate tax rate, a 38 percent gross up will create taxable dividends that reflect the amount of pre-tax corporate income received:

**EXAMPLE** Marin Ltd. is subject to a combined federal/provincial tax rate of 27.53623 percent. During 2019, the company has Taxable Income of $100,000. All of the Company's after tax income is paid to Mr. Marin, its only shareholder, as a dividend.

**ANALYSIS** The results at the corporate and individual levels are as follows:

| | |
|---|---|
| Corporate Taxable Income | $100,000.00 |
| Corporate Tax At 27.53623 Percent | ( 27,536.23) |
| Corporate After Tax Income And Eligible Dividends Paid | $ 72,463.77 |
| 38 Percent Gross Up [(38%)($72,463.77)] | 27,536.23 |
| Mr. Marin's Taxable Eligible Dividends | $100,000.00 |

7-78. You should note that the 38 percent gross up only works in situations where the corporation is taxed at a 27.53623 percent rate. (We have used 5 decimal places in these examples to eliminate the need for rounding.) If the corporate tax rate was higher, the taxable dividends would be less than the pre-tax corporate income. Correspondingly, if the tax rate was lower, the taxable dividends would be greater than the pre-tax corporate income.

## Eligible Dividend Tax Credit Procedure

7-79. The federal dividend tax credit for eligible dividends is equal to 6/11 (54.5455%) of the dividend gross up. This could also be expressed as 15.0198% of the grossed up dividends or 20.7273% of dividends received. In the Paragraph 7-77 example, this amount would be $15,019.80 which can be expressed as:

- 6/11 of the gross up = [(6/11)($27,536.23)], the calculation we will use in most of our examples, or;
- 15.0198% of grossed up dividends = [(15.0198%)($100,000)], or;
- 20.7273% of dividends received = [(20.7273%)($72,463.77)].

**Note** The popular press often refers to the dividend tax credit as either a percent of grossed up dividends or, alternatively, a percent of dividends received. In this text and related problem material, we will follow the tax legislation and express the dividend tax credit as a fraction of the gross up.

7-80. The 6/11 factor is the federal dividend tax credit. There is also an additional dividend tax credit available in each of the provinces and territories. For integration to be perfect, the combined federal/provincial dividend tax credit must be equal to the corporate taxes paid. As the gross up is designed to reflect corporate taxes paid, this means that the combined federal/provincial dividend tax credit must equal the gross up. This requires a provincial dividend tax credit of 5/11 or 45.4545 percent (6/11 + 5/11 = 54.5455% + 45.4545% = 100%).

7-81. The following table shows the actual lowest and highest dividend tax credit rates for 2019, as well as the average rate for the 10 provinces.

| **Eligible Dividends - 2019** | **Lowest** | **Highest** | **Average** |
|---|---|---|---|
| Provincial Dividend Tax Credit | | | |
| As Percentage Of 38% Gross Up | 19.6% | 50.8% | 36.2% |
| Federal + Provincial Dividend Tax Credit | 74.1% | 105.3% | 90.7% |

7-82. You should note that the average combined federal/provincial dividend tax credit rate is below 100 percent, the rate required for perfect integration. However, in the highest rate province (New Brunswick), it is above 100 percent.

7-83. A further point that should be made here is that the 27.54 (rounded) percent corporate rate that is assumed in the gross up of eligible dividends is higher than the combined federal/provincial tax rate on low income individuals in any of the provinces. A typical combined individual rate would be 23 percent (15 percent federal and 8 percent provincial). In this situation, integration will not work because, at this rate, the credit cannot compensate for the corporate taxes paid. This is illustrated by Mr. Plummer in the following example.

### Example Of Eligible Dividends

7-84. The following example illustrates how integration works when the dividend gross up is 38 percent and the federal dividend tax credit is equal to 6/11 of the gross up. We have noted that, for integration to work perfectly for eligible dividends, the corporate tax rate must be 27.53623 percent and the provincial dividend tax credit equal to 5/11 of the gross up.

**EXAMPLE** During 2019, Mr. Plummer and Ms. Black each have a business that produces $10,000 in Taxable Income. While they both live in the same province, Mr. Plummer's income is subject to a 15 percent federal tax rate and an 8 percent provincial tax rate. In contrast, Ms. Black's income is subject to a 33 percent federal tax rate and an 18 percent provincial tax rate. The provincial dividend tax credit is equal to 5/11 of the gross up and the combined federal/provincial tax rate on corporations is 27.54 percent.

**ANALYSIS - Direct Receipt Of Income** If Mr. Plummer and Ms. Black received the business income directly, the taxes paid and the after tax retention of the income would be as follows:

| | Mr. Plummer | Ms. Black |
|---|---|---|
| Taxable Income | $10,000 | $10,000 |
| Total Individual Tax Payable: | | |
| At 23 Percent (15% + 8%) | ( 2,300) | |
| At 51 Percent (33% + 18%) | | ( 5,100) |
| After Tax Retention - Direct Receipt | $ 7,700 | $ 4,900 |

**ANALYSIS - Incorporation Of Income** If the businesses were incorporated, and all of the corporate after tax income is paid out as dividends, the taxes paid and the after tax retention of the income would be as follows:

| | Mr. Plummer | Ms. Black |
|---|---|---|
| Corporate Taxable Income | $10,000 | $10,000 |
| Corporate Taxes At 27.54 Percent | ( 2,754) | ( 2,754) |
| Eligible Dividends Paid | $ 7,246 | $ 7,246 |
| | | |
| Eligible Dividends Received | $ 7,246 | $ 7,246 |
| Gross Up At 38 Percent [(38%)($7,246)] | 2,754 | 2,754 |
| Taxable Dividends (= Corporate Income) | $10,000 | $10,000 |
| | | |
| Individual Tax Before Dividend Tax Credit: | | |
| At 23 Percent (15% + 8%) | $2,300 | |
| At 51 Percent (33% + 18%) | | $5,100 |
| Less: Dividend Tax Credit | | |
| (= Corporate Taxes Paid) | | |
| [(6/11+ 5/11)($2,754)] | ( 2,754) | ( 2,754) |
| Total Individual Tax Payable | Nil | $2,346 |
| | | |
| Eligible Dividends Received | $7,246 | $7,246 |
| Total Individual Tax Payable | ( Nil) | ( 2,346) |
| After Tax Retention - Use Of Corporation | $7,246 | $4,900 |
| | | |
| After Tax Retention - Direct Receipt | $7,700 | $4,900 |

7-85. The rates in this example are those that are built into the gross up and tax credit procedures applicable to eligible dividends. That is, the corporate tax rate is 27.54 (rounded) percent and the provincial dividend tax credit is equal to 5/11 of the gross up. You will note

that, while Ms. Black's $4,900 of after tax retention is not changed by the use of a corporation, Mr. Plummer's after tax eligible dividends are $7,246, $454 less than the $7,700 that he would have retained on the direct receipt of the business income. This reflects the fact that the assumed corporate tax rate of 27.54 percent is 4.54 percent higher than his personal tax rate of 23 percent, a situation that cannot be corrected by a non-refundable credit against his tax payable. Note, however, if Mr. Plummer had other sources of income, this excess would offset the taxes on that income.

### Exercise Seven - 6

**Subject:** Dividend Income - Eligible Dividends

During 2019, Ms. Ellen Holt receives $15,000 in eligible dividends from taxable Canadian corporations. Her income is such that all additional amounts will be taxed at a 29 percent federal rate and a 14.5 percent provincial rate. Her provincial dividend tax credit for eligible dividends is equal to 30 percent of the gross up. Determine the total federal and provincial tax that will be payable on these dividends and her after tax retention.

**SOLUTION available in print and online Study Guide.**

## Gross Up And Tax Credit Procedures - Non-Eligible Dividends

### *Non-Eligible Dividend Gross Up Procedure*

7-86. As you may be aware, the government has phased in an increase in the small business deduction. This has resulted in reducing the rate of taxation on the active business income of Canadian controlled private corporations. In conjunction with this change, the gross up and tax credit procedures applicable to non-eligible dividends has been changing. For the years 2017 through 2019, the required gross up on these dividends has been as follows:

| | |
|---|---|
| 2017 | 17 Percent |
| 2018 | 16 Percent |
| **2019** | **15 Percent** |

7-87. The 2019 gross up rate of 15 percent is based on an assumed federal/provincial corporate tax rate of 13.043 percent. As illustrated in the following example, this corporate tax rate will allow for taxable dividends that reflect the amount of pre-tax corporate income received.

**EXAMPLE** Marin Ltd. is subject to a combined federal/provincial tax rate of 13.043 percent. During 2019, the company has Taxable Income of $100,000. All of the Company's after tax income is paid to Mr. Marin, its only shareholder, as a dividend.

**ANALYSIS** The results at the corporate and individual levels are as follows:

| | |
|---|---|
| Corporate Taxable Income | $100,000 |
| Corporate Tax At 13.043 Percent | ( 13,043) |
| Corporate After Tax Income And Non-Eligible Dividends Paid | $ 86,957 |
| 15 Percent Gross Up [(15%)($86,957)] | 13,043 |
| Mr. Marin's Taxable Non-Eligible Dividends | $100,000 |

7-88. As demonstrated in the preceding calculation, the 15 percent gross up has resulted in a taxable dividend that is equal to the $100,000 pre-tax corporate income that is required to pay the dividend. This is also the amount of income that Mr. Marin would have received directly had he chosen not to incorporate his source of income. Similar to the case with eligible dividends, the 15 percent gross up for non-eligible dividends only works with one corporate tax rate. It must be exactly 13.043 percent. If the corporate tax rate was higher, the

taxable dividends would be less than the pre-tax corporate income. Correspondingly, if the tax rate was lower, the taxable dividends would be greater than the pre-tax corporate income.

## *Non-Eligible Dividend Tax Credit Procedure*

7-89. Provided the corporate tax rate is 13.043 percent, the gross up procedure has served to increase Mr. Marin's Taxable Income to the $100,000 amount of corporate Taxable Income on which the non-eligible dividend payment was based. What is now required is a credit against Mr. Marin's Tax Payable to make up for the $13.043 in taxes that were paid at the corporate level. As we found with eligible dividends, to accomplish this goal, the combined federal/provincial tax credit has to be equal to 100 percent of the gross up.

7-90. As was the case with the gross up percentage, the federal component of the dividend tax credit was changed to reflect the reduction in the small business deduction. For the years 2017 through 2019, the credit is as follows:

| | |
|---|---|
| 2017 | 21/29 |
| 2018 | 8/11 |
| **2019** | **9/13** |

7-91. The 2019 credit of 9/13 can also be expressed as 9.0301 percent of taxable (i.e., grossed up) dividends or as 10.3846 percent of dividends received. In the example in Paragraph 7-87, this amount would be $9,030 which could be calculated as:

- 9/13 of the gross up = [(9/13)($13,043)], the calculation we will use in most of our examples as it follows tax legislation, or;
- 9.0301% of grossed up dividends = [(9.0301%)($100,000)], or;
- 10.3846% of dividends received = [(10.3846%)($86,957)].

7-92. In order for the combined federal/provincial dividend tax credit to equal 100 percent of the gross up, the 2019 provincial credit has to equal 4/13 or 30.7692 percent of the gross up. The following table shows the actual lowest and highest rates for 2019, as well as the average rate for 9 provinces, excluding Quebec (Quebec system is not comparable).

| Non-Eligible Dividends - 2019 | Lowest | Highest | Average |
|---|---|---|---|
| Provincial Dividend Tax Credit | | | |
| As Percentage Of 15% Gross Up | 6.0% | 25.8% | 19.1% |
| Federal + Provincial Dividend Tax Credit | 75.2% | 95.0% | 85.3% |

7-93. Note that all of these rates are below the 100 percent that is required for perfect integration.

## *Example Of Non-Eligible Dividends*

7-94. We have noted that, for non-eligible dividends, integration works perfectly, provided the corporate tax rate is 13.043 percent and the provincial dividend tax credit is equal to 4/13 of the gross up. The following illustration of this point uses the same two scenarios that were used in Paragraph 7-84 to illustrate the taxation of eligible dividends.

**EXAMPLE** During 2019, Mr. Plummer and Ms. Black each have a business that produces $10,000 in Taxable Income. While they both live in the same province, Mr. Plummer's income is subject to a 15 percent federal tax rate and an 8 percent provincial tax rate. In contrast, Ms. Black's income is subject to a marginal 33 percent federal tax rate and an 18 percent provincial tax rate. The provincial dividend tax credit is equal to 4/13 of the gross up and the combined federal/provincial tax rate on corporations is 13.043 percent.

**ANALYSIS - Direct Receipt Of Income** If Mr. Plummer and Ms. Black received the business income directly, the taxes paid and the after tax retention of the income would be as follows:

| | Mr. Plummer | Ms. Black |
|---|---|---|
| Taxable Income | $10,000 | $10,000 |
| Total Individual Tax Payable: | | |
| At 23 Percent (15% + 8%) | ( 2,300) | |
| At 51 Percent (33% + 18%) | | ( 5,100) |
| After Tax Retention - Direct Receipt | $ 7,700 | $ 4,900 |

**ANALYSIS - Incorporation Of Income** If the businesses were incorporated, and all of the corporate after tax income is paid out as dividends, the taxes paid and the after tax retention of the income would be as follows:

| | Mr. Plummer | Ms. Black |
|---|---|---|
| Corporate Taxable Income | $10,000 | $10,000 |
| Corporate Taxes At 13.043 Percent | ( 1,304) | ( 1,304) |
| Non-Eligible Dividends Paid | $ 8,696 | $ 8,696 |
| | | |
| Non-Eligible Dividends Received | $ 8,696 | $ 8,696 |
| Gross Up At 15 Percent [(15%)($8,696)] | 1,304 | 1,304 |
| Taxable Non-Eligible Dividends | $10,000 | $10,000 |
| | | |
| Individual Tax Before Dividend Tax Credit: | | |
| At 23 Percent (15% + 8%) | $2,300 | |
| At 51 Percent (33% + 18%) | | $5,100 |
| Less: Dividend Tax Credit | | |
| (= Corporate Taxes Paid) | | |
| [(9/13 + 4/13)($1,304)] | ( 1,304) | ( 1,304) |
| Total Individual Tax Payable | $ 996 | $3,796 |
| | | |
| Non-Eligible Dividends Received | $8,696 | $8,696 |
| Total Individual Tax Payable | ( 996) | ( 3,796) |
| After Tax Retention - Use Of Corporation | $7,700 | $4,900 |
| | | |
| After Tax Retention - Direct Receipt | $7,700 | $4,900 |

7-95. The rates in this example are those that are built into the gross up and tax credit procedures applicable to non-eligible dividends. That is, the corporate tax rate is 13.043 percent and the provincial dividend tax credit is equal to 4/13 of the gross up. As you would expect with the assumed corporate rate of 13.043 percent which is below the individual tax rates applicable to the two individuals, the after tax retention is the same, without regard to whether the $10,000 of income is received directly by the taxpayers or, alternatively, received indirectly after being flowed through a corporation. This is in contrast to the eligible dividend case. In that case (Paragraph 7-84), Mr. Plummer did not have sufficient Tax Payable to use all of the available dividend tax credit, resulting in Mr. Plummer being worse off when the income source was flowed through a corporation.

## Exercise Seven - 7

**Subject:** Dividend Income - Non-Eligible Dividends

During 2019, Mr. John Johns receives $17,000 in non-eligible dividends from a taxable Canadian corporation. His income is such that all additional amounts will be taxed at a 29 percent federal rate and a 12 percent provincial rate. His provincial dividend tax credit for non-eligible dividends is equal to 30 percent of the gross up. Determine the total federal and provincial tax that will be payable on these dividends and his after tax cash retention.

**SOLUTION available in print and online Study Guide.**

### Comparison Of Investment Returns

7-96. The table which follows shows, for an individual in the maximum tax bracket applicable in the stated province, the tax rates on various types of investment income. As you will note, the rates vary significantly, both between provinces and with the type of investment income.

**Maximum 2019 Tax Rates For Individuals**
**By Type Of Investment Income In Selected Provinces**

| | Interest Income | Capital Gains* | Non-Eligible Dividends | Eligible Dividends |
|---|---|---|---|---|
| Alberta | 48.0% | 24.0% | 42.6% | 31.7% |
| British Columbia | 49.8% | 24.9% | 44.6% | 31.4% |
| New Brunswick | 53.3% | 26.7% | 47.8% | 33.5% |
| Quebec | 53.3% | 26.7% | 46.3% | 40.0% |
| Ontario | 53.5% | 26.8% | 47.4% | 39.3% |

*Only one-half of capital gains are included in Taxable Income.

7-97. As only one-half of any capital gains are subject to tax, such gains are clearly the most favourable type of investment income. While the tax rates on dividends are not as attractive as those on capital gains, these rates are clearly better than the rates applied to interest income. The fact that eligible dividends are taxed at lower rates than is the case with non-eligible dividends reflects the fact that corporations that pay these dividends are generally subject to higher corporate rates than those applicable to corporations paying non-eligible dividends.

**We suggest you work Self Study Problems Seven-3, 4, 5, and 6 at this point.**

# Income Trusts

## How Do Trusts Work?

7-98. While this subject is covered in detail in Chapter 19, Trusts And Estate Planning, it is impossible to discuss the taxation of income trusts without an understanding of the basic nature of trusts. Trusts are essentially flow-through entities. What this means is that, if the income earned by a trust is distributed immediately to its beneficiaries, the trust will pay no taxes. Consistent with this, the beneficiaries of the trusts will pay taxes on that income as though they had received it directly from its source. If a trust earns $100,000 in interest and distributes the full amount to the beneficiaries, the trust will pay no income taxes and the beneficiaries will be taxed on the $100,000 of interest income.

7-99. The other important characteristic of trusts, including publicly traded income trusts, is that, in general, certain types of income retain their character as they flow through the trust.

Although ITA 108(5) states that income distributed from a trust should be treated as income from property, there are specific exceptions that allow for flow through treatment. Most types of income that receive favourable tax treatment are included in the list of exceptions. For example, capital gains, taxable dividends and capital dividends that are earned in a trust are distributed to beneficiaries as capital gains, taxable dividends and capital dividends, thereby receiving the favourable treatment that these types of income have when they are received directly. Although there are other exceptions on the list, these are the important ones and the ones we will use in our material. Since business income is not on the exceptions list, business income earned in a trust is distributed to beneficiaries as property income.

## Investments In Publicly Traded Trusts

### *Comparison Of Tax Consequences*

7-100. The use of trusts has been common for many years for both estate planning (e.g., a deceased parent leaves his assets in a trust for his children) and for retirement savings (e.g., RRSPs are trusts). What is different here is that these trusts were created to raise financing through the public sale of their units, with the funds used to acquire various types of businesses.

> **EXAMPLE** The Zorin Real Estate Income Trust sells 1,000,000 units at a price of $50 per unit. The $50 million that was raised is used to acquire the assets and operations of Zorin Ltd., a Canadian public company. The trust is committed to distributing 100 percent of the Taxable Income from the Zorin operations to its unitholders.
>
> Prior to the transfer of assets to the income trust, Zorin Ltd.'s income was subject to a combined federal/provincial corporate tax rate of 26 percent. Its shareholders were subject to a combined federal/provincial rate on dividends received of 37 percent. Unit holders of the Zorin Income Trust will be subject to a combined federal/provincial rate of 51 percent on distributions from the income trust.

7-101. The tax consequences of this transaction are illustrated in Figure 7-2 (following page).

- Prior to the existence of the trust, the income from the Zorin operations was subject to a corporate tax rate of 26 percent. The after tax income could then be distributed to shareholders as dividends. In the Example, these dividends were taxed at a combined federal/provincial rate of 37 percent. The resulting overall tax rate on the income stream channeled through Zorin Ltd. was 53 percent [26% + (37%)(1 - 26%)].
- In contrast, the Zorin Trust will pay no taxes if it distributes all of its income. However, the distributions to its unit holders will be taxed as ordinary income. In the Example, that would be at a rate of 51 percent. Unlike the situation when the income from the Zorin operations was subject to corporate taxes, there will be no dividend gross up and tax credit benefits.

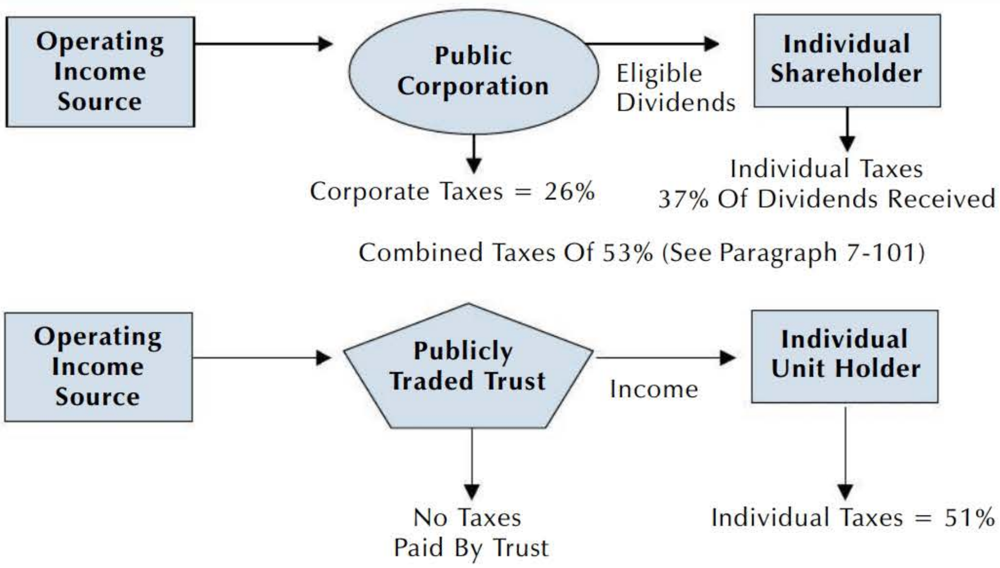
7-102. This example illustrates that, in situations where normal provincial rates and dividend tax credits prevail, income that is flowed through an income trust will be subject to lower taxes than would be the case if the same stream of income was flowed through a public corporation. While the amount of the advantage may be more or less in individual provinces, results will generally favour the use of income trusts.

### *SIFT Trusts And REITs*

7-103. It is not surprising that income trusts became an extremely popular investment vehicle since:

- They often provided an overall tax savings as illustrated in the preceding example.
- They had to distribute all of their earnings to unit holders in order to avoid taxes at the trust level.

**Figure 7 - 2**
**Comparison Of Taxation Of Operating Income For Corporations vs Trusts**




- Most income trusts were committed to paying out 100 percent of the cash flows from the acquired operations. As these cash flows would typically exceed both accounting and tax income, a part of the distribution was received as a tax free return of capital.

7-104. However, they provided a significant problem in terms of tax policy. As shown in Figure 7-2, there was an assumption that amounts distributed to unit holders would be subject to tax. Over time, it became clear to the government that this was not always the case. Specifically:

> **Non-Resident Investors** If the income trust units are held by a non-resident investor, they may not be subject to any Canadian taxes. At most, the taxes will be at the low Part XIII rates. (See Chapter 20, Issues In International Income.)
>
> **Tax Exempt Entities (e.g., RPPs, RRSPs, Other Tax Exempt Entities)** If the income trust units are held inside a tax exempt entity, the distributions will not be subject to tax at the time they are received from the income trust. While they will eventually be subject to tax when they are withdrawn from the registered plan, this taxation could be deferred for 30 to 40 years. (See Chapter 10 which covers retirement savings.)

7-105. Because of these situations, the government concluded that it would no longer allow such a major leakage of tax revenues. Legislation was introduced under which most income trusts were designated as Specified Investment Flow Through (SIFT) trusts. Under this legislation most SIFT trusts are taxed at roughly the combined federal/provincial rate applicable to public corporations. This has the effect of removing most of the available tax advantage. As a consequence, the income trusts that were subject to this legislation converted to a conventional corporate structure.

7-106. For a variety of reasons, income trusts that were involved in owning real estate were exempted from this legislation. These real estate investment trusts (REITs) continue to enjoy the previously cited advantages associated with the income trust structure. Because of this, REITs continue to provide investors with very attractive yields, making them an important and popular choice for many investors. Given this popularity, we are providing coverage of the basic tax procedures associated with REITs.

## Taxation Of Real Estate Investment Trusts (REITs)

### Distributions

7-107. Most income trusts are committed to distributing all of their net cash flow to unit holders. As you are aware from your accounting courses, this amount will not be equal to accounting income as determined under GAAP. In most cases, because of non-cash deductions for amortization, the net cash flow will exceed accounting net income. This means that trust distributions will, in general, consist of an income distribution, combined with an additional distribution that represents a return of capital (i.e., the return of amounts invested).

7-108. To the extent that distributions reflect income that has been earned in the trust, they will be taxed in the hands of individual investors at the usual federal and provincial rates. As discussed in Paragraph 7-99, if the trust earned capital gains or dividends (eligible, non-eligible or capital), the distribution of these amounts will be treated as capital gains or dividends (eligible, non-eligible or capital) by the recipient of the distributions. On the other hand, business income will be distributed to unit holders as property income.

7-109. To the extent that the trust distribution exceeds the trust's income, the excess will be treated as a return of capital. These distributions will be received by individual investors on a tax free basis.

### Adjusted Cost Base

7-110. The determination of the adjusted cost base for income trust units is complicated by the fact that some part of its distributions may be a tax free return of capital. While such distributions are not taxed currently, they do reduce the adjusted cost base of the units held by an investor. This means that the adjusted cost base of an investment in income trust units is equal to the cost of the units, less any amounts of capital returned as part of the trust's distributions.

7-111. A further complication relates to the fact that many income trusts have distribution reinvestment plans (DRIPs). To the extent an investor chooses to have his distributions reinvested, the amount reinvested will be an addition to the adjusted cost base of the units held. This will be accompanied by an increase in the number of units held. Note that, if the investor disposes of a part of his holding, the adjusted cost base of the units sold will be based on the average cost of all units held (see Chapter 8 on identical properties).

**EXAMPLE** On January 1, 2019, Joan Arden acquires 1,000 units of the Newcor Income Trust at a total cost of $100,000 or $100 per unit. On December 15, 2019, the trust distributes $6 per unit, $2 of which is a return of capital and $4 of which is business income earned in the trust that is distributed as property income. At this time, the trust has a purchase price of $110 per unit.

**ANALYSIS** Regardless of whether or not Ms. Arden reinvests the distribution, she will include $4,000 [($4)(1,000 units)] in her 2019 Net Income For Tax Purposes. If Ms. Arden chooses not to reinvest the distribution, she would have received $6,000 [(1,000)($6)] in cash, her Net Income would be increased by $4,000 and her 1,000 units would have an adjusted cost base, after the $2,000 [($2)(1,000)] return of capital, of $98 per unit [($100,000 - $2,000) ÷ 1,000].

If the $6,000 distribution is reinvested in additional trust units at a cost of $110 per unit, her holding increases to 1,054.55 [1,000 + ($6,000 ÷ $110)] units. Her adjusted cost base would be calculated as follows:

| | Adjusted Cost Base | No. Of Units |
|---|---|---|
| Original Investment | $100,000 | 1,000.00 |
| Reinvestment Of Distribution | 6,000 | 54.55 |
| Tax Free Return Of Capital | ( 2,000) | N/A |
| Adjusted Cost Base/Number Of Units | $104,000 | 1,054.55 |

This will result in an average cost for her units of $98.62 ($104,000 ÷ 1,054.55).

## Exercise Seven - 8

**Subject:** Income Trust Distributions

On January 1, 2019, John Dore acquires 2,000 units of Xeron Income Trust at $55 per unit, a total cost of $110,000. During 2019, the trust distributes $5.00 per unit, $1.50 of which is a return of capital and $3.50 of which is a business income distribution. John has asked the trust to reinvest all distributions. The $5.00 per unit distribution was reinvested at a cost of $57 per additional unit. What are the tax consequences to John of the 2019 distribution and its reinvestment? What will be his adjusted cost base per unit after the reinvestment?

**SOLUTION available in print and online Study Guide.**

# Mutual Funds

## Objective

7-112. Mutual funds are organized to provide investment management, largely for individual taxpayers. The basic idea is that investors provide funds to these organizations which they, in turn, use to make direct investments in stocks, bonds, and other types of investment property. As will be discussed in the following material, mutual funds can be organized as either trusts or as corporations.

## Organization

### *Mutual Fund Trusts*

7-113. In Canada, most mutual funds are organized as trusts. As was discussed in Paragraph 7-98, trusts are flow-through entities. This means that, if all of the income earned in the trust is distributed to beneficiaries, no taxes will be paid at the trust level.

7-114. Mutual fund trusts are generally structured to make use of this flow-through feature. In most cases, the by-laws will require that the trust distribute, to the unit holders of the trust, all of the income it earns during a taxation year. This will free the mutual fund trust from any obligation to pay taxes on income earned during the year.

### *Mutual Fund Corporations*

7-115. Mutual fund corporations are less common than mutual fund trusts. In this case, the mutual fund will be taxed at regular corporate tax rates on the investment income that it earns. As the investors will be shareholders rather than trust unit holders, in general, their distributions will be treated as dividends subject to the usual gross up and tax credit procedures. Note, however, ITA 131 provides an election that allows the dividends of mutual fund corporations to be treated as capital gains in the hands of shareholders. Like mutual fund trusts, mutual fund corporations are usually committed to distributing all of the after tax income earned during a taxation year to their shareholders.

7-116. There are other complications here involving capital dividends and refundable taxes on investment income that go beyond the scope of the material in this Chapter.

## Distributions

### *Mutual Fund Trusts*

7-117. As noted in our discussion of income trusts in Paragraph 7-98, an important feature of the trust legal form is that certain types of income can retain their tax characteristics as they flow through the trust. For example, if the mutual fund trust has a capital gain, it will be distributed to investors as a capital gain. This means that, when a mutual fund provides an investor with an information return (a T3, if the fund is organized as a trust), it will indicate the various types of income that are included in its distributions. These types will commonly include:

- **Eligible Dividends** These amounts will be subject to the gross up and tax credit procedures that were previously discussed in this Chapter. Eligible dividends received by the trust will be distributed as eligible dividends to the trust unit holders.
- **Canadian Interest Income** These amounts will be taxed as ordinary interest income.
- **Capital Gains** As with capital gains earned directly by the individual, only one-half of these amounts will be subject to taxes (this type of income is discussed in Chapter 8).
- **Foreign Non-Business (Interest And Dividend) Income** These amounts are taxable on the same basis as Canadian interest income. As will be discussed in a later section of this Chapter, the gross amount of this income will be included in income, with amounts withheld at the foreign source being eligible for tax credit treatment.
- **Capital Distributions** A fund can make distributions that exceed its income for the year. These are identified as a return of capital and are received tax free. They do, however, reduce the adjusted cost base of the investment.

### Mutual Fund Corporations

7-118. Shareholders in mutual fund corporations receive dividends from the after tax income earned by the corporation's investments. Unlike the situation with mutual fund trusts, the investment income earned by the mutual fund corporation does not retain its tax features when distributed to shareholders. Without regard to whether the income of the mutual fund corporation was interest, dividends, or capital gains, it is paid out as taxable dividends.

7-119. Dividends paid by mutual fund corporations will usually be eligible dividends and these eligible dividends will qualify for the usual gross up and tax credit procedures. As was discussed earlier in this Chapter, this provides the recipient with a reduced rate of taxation.

## Adjusted Cost Base

### Mutual Fund Trusts

7-120. Determining the adjusted cost base of a mutual fund trust unit uses procedures that are similar to those used in determining the adjusted cost base of an income trust unit. Any distributions that are reinvested in the fund increase the adjusted cost base of the units of a mutual fund trust. The balance is reduced by any amounts that represent a tax free return of capital. Amounts of income that are distributed to investors do not alter the adjusted cost base of the investment.

**EXAMPLE** On October 15, 2019, Martin Diaz purchases 1,000 units of CIC Growth Fund for $7.30 per unit. On December 1, 2019, the fund has an interest income distribution of $.50 per unit. At this time, the fund has a purchase price of $6 per unit.

**ANALYSIS** Regardless of whether or not Mr. Diaz reinvests the distribution, he will include $500 [($0.50)(1,000 units)] in his 2019 Net Income For Tax Purposes. If Mr. Diaz chooses not to reinvest the distribution, he will receive $500 in cash. He would then have 1,000 units with his original adjusted cost base of $7.30 per unit. Alternatively, if the distribution is reinvested, he will receive 83.33 ($500 ÷ $6) additional units. This will leave him with a holding of 1,083.33 units with an adjusted cost base of $7,800 ($7,300 + $500), or $7.20 ($7,800 ÷ 1,083.33) per unit.

### Mutual Fund Corporations

7-121. In general, the adjusted cost base of a mutual fund corporation will not be altered by distributions that are made by the corporation. The exception to this would be a situation where the corporation distributed a return of capital. This, however, would rarely occur. In addition, coverage of this type of situation goes beyond the material covered in this Chapter (see Chapter 14).

7-122. If the holder of the shares decides to reinvest the amounts distributed, the cost of the additional shares is added to the adjusted cost of the original shares. Such reinvestments are less common with mutual fund corporations than they are with mutual fund trusts.

## Exercise Seven - 9

**Subject:** Mutual Fund Distributions

Ms. Marissa Tiompkins owns 3,500 units of the RB Small Cap Fund, a mutual fund trust. These units were purchased at a price of $11.25 per unit, for a total value of $39,375. There have been no changes in her adjusted cost base prior to the current year. On September 1 of the current year, the Fund has an income distribution of $0.30 per unit, a total of $1,050 for Ms. Tiompkins. She reinvests this amount to acquire additional fund units at $13.00 per unit. What will be her adjusted cost base per unit after the reinvestment?

**SOLUTION available in print and online Study Guide.**

**We suggest you work Self Study Problem Seven-7 at this point.**

# Other Types Of Dividends

## Capital Dividends

7-123. When a corporation has a capital gain, only one-half of this amount will be taxable. However, the full amount of the proceeds of disposition is still held by the corporation. In the absence of a special provision, this full amount would be taxed if it were distributed to a shareholder as a dividend. In order to avoid this result for private companies only, one-half of the capital gain will be allocated to a balance referred to as a "capital dividend account" (as you will find in Chapter 14, several other items are allocated to this account).

7-124. When the amounts allocated to this capital dividend account are paid out to shareholders of private companies, they will be received by Canadian resident investors on a totally tax free basis. Also to be noted here is that, for Canadian residents, such capital dividends do not have to be deducted from the adjusted cost base of the investor's shares.

## Stock Dividends

7-125. A stock dividend involves a pro rata distribution of additional shares to the existing shareholders of a company. For example, if the XYZ Company had 1,000,000 shares outstanding and it declared a 10 percent stock dividend, the Company would be distributing 100,000 new shares to its present shareholders on the basis of one new share for each ten of the old shares held.

7-126. While there is no real change in anyone's financial position as a result of this transaction, in the accounting records it is accompanied by a transfer from the Company's Retained Earnings to contributed capital or paid up capital. The amount of this transfer is normally the fair market value of the shares to be issued, determined on the dividend declaration date.

7-127. For tax purposes, stock dividends are dealt with in the same manner as cash dividends. The value of the dividend is based on the amount of the increase in the paid up capital of the issuer. In some cases, provincial legislation requires that this amount be equal to the fair market value of the shares issued. In other provinces, the increase can be established at the discretion of the directors. Whatever the amount, it is treated as a cash dividend and subject to the eligible or non-eligible gross up and tax credit procedures. As this amount has been subject to tax, it is added to the adjusted cost base of all of the shares owned by the investor.

7-128. This approach places the investor in the position of having to pay taxes on an amount of dividends that has not been received in cash, an unfavourable situation with respect to the investor's cash flows. As a consequence, public companies make little use of stock dividends. However, they are often used in the tax planning arrangements of private companies.

### Exercise Seven - 10

**Subject:** Stock Dividends

Morgna Inc. has 2,000,000 common shares outstanding. John Morgna acquired 10 percent of these shares at a cost of $12 per share. During the current year, when the shares are trading at $15 per share, the Company declares a 10 percent stock dividend which it designates as eligible. The Company transfers the amount of the stock dividend to paid up capital. What are the tax consequences to John Morgna of this transaction? Your answer should include the adjusted cost base per share of his holding.

**SOLUTION available in print and online Study Guide.**

# Foreign Source Income

## General Rules

7-129. As Canadian taxation is based on residency, income that has a foreign source must be included in full in the calculation of Net Income For Tax Purposes of any Canadian resident. This is complicated by the fact that many foreign jurisdictions levy some form of withholding tax on such income.

7-130. The general approach to this situation is to require Canadian residents to include 100 percent of any foreign income earned in their Net Income For Tax Purposes. They then receive a credit against Tax Payable for taxes withheld in the foreign jurisdiction. The basic idea behind this approach is to have the combined foreign and Canadian tax on this income be the same as that which would be levied on the same amount of income earned in Canada.

**EXAMPLE** An individual earned $1,000 in a foreign jurisdiction. As the authorities in that jurisdiction withhold $100, his net receipt is $900. The individual's marginal tax rate is 45 percent.

**ANALYSIS** The Canadian Tax Payable on the amount received would be calculated as follows:

| | |
|---|---|
| Amount Received | $ 900 |
| Foreign Tax Withheld | 100 |
| Increase In Taxable Income | $1,000 |
| Rate | 45% |
| Tax Payable Before Credit | $ 450 |
| Foreign Tax Credit (Equal To Withholding) | ( 100) |
| Canadian Tax Payable | $ 350 |

Note that the combined foreign and Canadian tax equal $450 ($350 + $100), the same amount that the individual would have paid on the domestic receipt of $1,000 of income.

## Foreign Non-Business (Property) Income

7-131. Following the general rule, 100 percent of foreign source non-business income is included in Net Income For Tax Purposes. However, for individuals, the credit against Tax Payable that is provided under ITA 126(1) is limited to a maximum of 15 percent of the foreign source non-business income. If the withheld amounts exceed 15 percent, the excess can be deducted under ITA 20(11).

## Foreign Business Income

7-132. In the case of foreign source business income, there is no direct limitation on the use of the amounts withheld as a credit against Tax Payable and, correspondingly, no deduction in the calculation of Net Income For Tax Purposes for any part of the amount withheld by the foreign jurisdiction. The following example compares the difference in the treatment of tax withheld on foreign non-business income and foreign business income.

**EXAMPLE** Mr. Grant, a taxpayer with a marginal tax rate of 45 percent, earns foreign source income of $1,000. The foreign government withholds 40 percent ($400) and he receives $600.

**ANALYSIS** The Canadian Tax Payable on the amount received assuming it is foreign non-business income or business income would be calculated as follows:

| | Non-Business Income | Business Income |
|---|---|---|
| Amount Received | $ 600.00 | $ 600.00 |
| Foreign Tax Withheld | 400.00 | 400.00 |
| Inclusion For Foreign Income | $1,000.00 | $1,000.00 |
| Deduction Of Excess Withholding [$400 - (15%)($1,000)] | ( 250.00) | N/A |
| Increase In Taxable Income | $ 750.00 | $1,000.00 |
| Rate | 45% | 45% |
| Tax Payable Before Credit | $ 337.50 | $ 450.00 |
| Foreign Tax Credit [(15%)($1,000)] | ( 150.00) | |
| Foreign Tax Credit (Amount Withheld) | | ( 400.00) |
| Canadian Tax Payable | $ 187.50 | $ 50.00 |

**ANALYSIS - Foreign Non-Business Income** Income of $750 will be included in Net Income For Tax Purposes. Foreign and Canadian taxes combined would be $587.50 ($400 + $187.50), well in excess of the $450 he would have paid on $1,000 of Canadian source income. This illustrates that the availability of the deduction does not make up for the fact that the tax credit is limited to 15 percent. The value of a $1 tax credit is $1, whereas the value of a $1 deduction to Mr. Grant is only $0.45 [($1)(45%)].

**ANALYSIS - Foreign Business Income** The gross income of $1,000 will be included in Net Income For Tax Purposes. The full $400 of withholding will be used to calculate a credit against his Canadian Tax Payable of $450 [(45%)($1,000)]. This leaves $50 in Canadian Tax Payable and a total tax of $450 ($400 + $50). This is the same amount that he would have paid on the receipt of $1,000 in Canadian source income.

### Exercise Seven - 11

**Subject:** Foreign Source Income

Norah Johns has foreign source income of $30,000 during the current year. As the foreign jurisdiction withholds 25 percent of such income, she only receives $22,500. She has other income such that this foreign source income will be taxed at a marginal federal tax rate of 29 percent. Determine the amount by which this foreign income would increase Norah's Taxable Income and federal Tax Payable, assuming that the foreign source income (1) is non-business income and (2) is business income.

**SOLUTION available in print and online Study Guide.**

# Shareholder Benefits

7-133. Shareholders sometimes receive benefits from a corporation that are directly related to their investment in the shares of that corporation. Examples would include:

- A corporation providing a shareholder with an automobile for personal use.
- A corporation building a swimming pool at a shareholder's personal residence.
- A corporation providing a shareholder with an interest free loan.

7-134. Such benefits are taxable as property income, largely under ITA 15(1) of the *Income Tax Act*. Further, in some cases, the corporation is not able to deduct the cost of providing the benefit. The following simple example illustrates some of the potential tax problems related to shareholder benefits.

> **EXAMPLE** A corporation provides a shareholder with a $10,000 holiday trip to Italy.
>
> **ANALYSIS** ITA 15(1) requires the inclusion of the $10,000 cost of the trip in the income of the shareholder. Despite the fact that this amount is now being taxed in the hands of the shareholder, the corporation cannot deduct the cost of the trip.

7-135. There are a number of complications that result from shareholder benefits, particularly those associated with low or interest free loans. These complications will be given detailed coverage in Chapter 15, Corporate Taxation And Management Decisions.

# Tax Credits Revisited

## Dividend Tax Credits

7-136. Most of the credits that are available to individuals in determining their Tax Payable are discussed in Chapter 4. However, because an understanding of some amount of additional material was required, it was appropriate to defer coverage of a few of these credits to later Chapters. Given the content of this Chapter, we have added two additional credits.

7-137. The first of these was the dividend tax credit and there are two different versions of this credit:

> **Eligible Dividends** For eligible dividends received from taxable Canadian corporations, the federal dividend tax credit is equal to 6/11 of a 38 percent gross up. It can also be calculated as 15.0198 percent of the grossed up amount of dividends or, alternatively, as 20.7273 percent of dividends received.
>
> **Non-Eligible Dividends** For non-eligible dividends received from taxable Canadian corporations, the federal dividend tax credit is equal to 9/13 of a 15 percent gross up. It can also be calculated as 9.0301 percent of the grossed up amount of dividends or, alternatively, as 10.3846 percent of dividends received.

## Foreign Income Tax Credits

7-138. The other tax credit that was introduced in this Chapter was the credit for foreign taxes paid on foreign source income. For the purposes of this Chapter, we have indicated that this credit is equal to the amount of foreign taxes withheld, subject to the limitation that, in the case of foreign source non-business income earned by individuals, the credit is limited to 15 percent of the foreign source income.

7-139. This, however, is not the end of the story. For both foreign source non-business income and foreign source business income, the amount of the credit may be limited by the total amount of taxes paid by the individual. This limit is based on an equation that requires an understanding of loss carry overs. As this material has not been covered at this point, we will have to return to coverage of the credits for foreign taxes paid when we revisit Taxable Income and Tax Payable For Individuals in Chapter 11.

**We suggest you work Self Study Problems Seven-8 and 9 at this point.**

**Additional Supplementary Self Study Problems Are Available Online.**

# Key Terms Used In This Chapter

7-140. The following is a list of the key terms used in this Chapter. These terms, and their meanings, are compiled in the Glossary located at the back of the Study Guide.

| | |
|---|---|
| Accrual Basis | Eligible Dividends |
| Business Income | Foreign Taxes Paid Credit |
| Capital Dividend | Income Trust |
| Capital Dividend Account | Interest Income |
| Cash Basis | Mutual Fund |
| Cash Damming | Net Business Income |
| Disappearing Source Rules | Net Property Income |
| Dividend Gross Up | Non-Eligible Dividends |
| Dividend Tax Credit | Property Income |
| Dividends | Stock Dividend |

# References

7-141. For more detailed study of the material in this Chapter, we refer you to the following:

| | |
|---|---|
| ITA 12(1)(c) | Interest |
| ITA 12(1)(g) | Payments Based On Production Or Use |
| ITA 12(3) | Interest Income |
| ITA 12(4) | Interest From Investment Contract |
| ITA 12(11) | Definitions (Investment Contract) |
| ITA 15 | Benefits Conferred On Shareholder |
| ITA 20(1)(c) | Interest |
| ITA 20(1)(f) | Discount On Certain Obligations |
| ITA 20(14) | Accrued Bond Interest |
| ITA 20.1 | Borrowed Money Used To Earn Income From Property |
| ITA 82(1)(b) | Taxable Dividends Received |
| ITA 121 | Deduction For Taxable Dividends |
| ITA 126 | Foreign Tax Deduction |
| | |
| S3-F6-C1 | Interest Deductibility |
| S5-F2-C1 | Foreign Tax Credit |
| | |
| IT-67R3 | Taxable Dividends From Corporations Resident In Canada |
| IT-195R4 | Rental Property - Capital Cost Allowance Restrictions |
| IT-295R4 | Taxable Dividends Received After 1987 By A Spouse |
| IT-396R | Interest Income |
| IT-434R | Rental Of Real Property By Individual |
| IT-443 | Leasing Property - Capital Cost Allowance Restrictions |
| IT-462 | Payments Based On Production Or Use |
| IT-506 | Foreign Income Taxes As A Deduction from Income |
| | |
| T4036 | Rental Income Guide |

# Problems For Self Study (Online)

To provide practice in problem solving, there are Self Study and Supplementary Self Study problems available on MyLab Accounting.

Within the text we have provided an indication of when it would be appropriate to work each Self Study problem. The detailed solutions for Self Study problems can be found in the print and online Study Guide.

We provide the Supplementary Self Study problems for those who would like additional practice in problem solving. The detailed solutions for the Supplementary Self Study problems are available online, not in the Study Guide.

The .PDF file "Self Study Problems for Volume 1" on MyLab contains the following for Chapter 7:

- 9 Self Study problems,
- 6 Supplementary Self Study problems, and
- detailed solutions for the Supplementary Self Study problems.

# Assignment Problems

(The solutions for these problems are only available in the solutions manual that has been provided to your instructor.)

### *Assignment Problem Seven - 1*

***(Interest Deductibility - 4 Cases)***

Each of the following independent Cases involves the payment of interest and the issue of whether the interest will be deductible for tax purposes.

**Case A** Thomas Sanjuan finances the acquisition of an income producing property. The cost of the property is $435,000 and Thomas finances 100 percent of the purchase. The investment proves successful, with the property being sold for $610,000. He uses the proceeds of the sale to acquire two properties with costs of $495,000 and $115,000 respectively. Explain how the original $435,000 proceeds from the loan can be allocated to the two properties.

**Case B** Tamara Sherrell has a trading account which holds equity securities with a current fair market value of $1,500,000. She would like to purchase a new Bentley for $325,000. Her bank will finance her purchase with a $325,000 loan that requires interest to be paid at a rate of 8.3 percent. However, as her equity securities are in a margin account, she can use her margin balance to borrow the $325,000 at a rate of 3.25 percent. She chooses the latter approach.

During the year, she pays interest on this loan of $10,500. Also during the year, the securities in her trading account pay total dividends of $75,000. Can she deduct the $10,500 of interest against the dividend income generated by the securities in her trading account? Explain your conclusion.

**Case C** Manuel Pettie takes out a mortgage on his house for $500,000 and immediately transfers the entire amount to his brokerage account to invest in publicly traded securities. Relying solely on company names that come to him in his dreams, he makes some very bad investment choices. As a result, after one year, his securities are worth only $240,000. Feeling very discouraged, he sells all of the securities and uses the proceeds to reduce the loan balance. He will not have the resources to pay off the remaining $260,000 until he receives $500,000 from his trust fund in 2 years. Is the interest on the mortgage deductible before he sells the shares? If so, does this change after he sells the shares? Explain your conclusion.

**Case D** Bo Godina borrows $220,000 in order to purchase an income producing property for that same amount. The results from this investment are not promising and, as a result, he sells the investment for $150,000. He uses these funds to buy two properties. The first property costs $35,000, while the second costs $115,000. How will the $220,000 in borrowing be linked to the two properties?

### *Assignment Problem Seven - 2*

***(Rental Income Including CCA)***

During 2019, Ms. Alice Busting owns four residential rental properties. Relevant information on these properties is as follows:

| | 26 Hart Street | 32 Barton Boulevard | 14 Mark Avenue | 96 Flagler Street |
|---|---|---|---|---|
| CCA Class | 1 | 1 | 3 | 1 |
| Capital Cost Of Building | $1,180,000 | $307,500 | $1,033,750 | $570,000 |
| January 1, 2019 UCC | Nil | 266,250 | 703,250 | 514,800 |

Rental receipts and expenses, not including CCA, for year ending December 31, 2019 are as follows:

| | 26 Hart Street | 32 Barton Boulevard | 14 Mark Avenue | 96 Flagler Street |
|---|---|---|---|---|
| Rental Receipts | $79,500 | $16,000 | $63,000 | $46,500 |
| Property Taxes | ( 17,756) | ( 12,113) | ( 15,500) | ( 18,550) |
| Interest Charges | ( 51,625) | ( 5,250) | ( 30,000) | ( 12,750) |
| Other Expenses (Not Including CCA) | ( 4,500) | ( 1,375) | ( 6,750) | ( 10,500) |
| Net Rental Income (Loss) Before CCA | $ 5,619 | ($ 2,738) | $ 10,750 | $ 4,700 |

**Other Information:**

1. The property at 26 Hart Street was acquired during 2019 for $1,180,000.
2. The building at 32 Barton Boulevard was sold during 2019 for $231,000.

   Ms. Busting had furnished this property several years ago at a cost of $28,750. The UCC for these Class 8 assets was $4,498 on January 1, 2019. Given the condition of the furnishings, they were simply given to the former tenants who agreed to take them when they moved out.
3. During 2019, Ms. Busting spent $78,750 on improvements to the property at 14 Mark Avenue. While none of the changes were required, the tenant insisted on the changes before he was prepared to renew his lease. These improvements will also enhance the value of this property.
4. The building at 96 Flagler Street was sold during 2019 for $653,000.

**Required:** Calculate Ms. Busting's minimum net rental income for 2019. You should provide a separate CCA calculation for each property and specify how much CCA should be taken for each building. Include in your solution any tax consequences associated with the sale of the two buildings and the disposition of the furniture.

### Assignment Problem Seven - 3

#### (Rental Income)

On March 1, 2018, Ms. Fox acquires a residential duplex for a total cost of $725,000. Of this total, it is estimated that the land has a value of $150,000 at the time of the acquisition. The two units are identical in size and, for purposes of allocation to a CCA Class, the property is considered to be a single unit.

Before the end of March, 2018, both units were rented. The tenants occupying one of the units asked that, in return for an additional amount of rent, Ms. Fox furnish the unit. Furniture and appliances for the unit were acquired by Ms. Fox on April 1, 2018 at a cost of $18,500.

During the year ending December 31, 2018, rents on the two units totaled $68,500. Expenses, other than CCA, totaled $28,000.

Late in 2019, the tenants in the furnished unit moved out. As Ms. Fox did not wish to continue renting the unit on a furnished basis, she sold the furniture and appliances to the departing tenants for $14,000.

During 2019, the two units generate total rent of $45,000. Ms. Fox incurred expenses, other than CCA, of $32,000.

Ms. Fox deducts the maximum CCA allowable in both years.

**Required**: Calculate Net Rental Income for each of the two years 2018 and 2019. Also, determine the UCC balances on January 1, 2020. Include in your solution any tax consequences associated with the sale of the furniture and appliances.

### Assignment Problem Seven - 4

#### (Dividend vs. Interest Income)

Cindy, Charlotte and Carol Brock are sisters who are Canadian residents. Over the years, they have enjoyed varying degrees of economic success. As a consequence, they are currently subject to significantly different tax rates. This is shown in the following table:

| | Cindy | Charlotte | Carol |
|---|---|---|---|
| Federal Marginal Tax Rate | 15% | 26% | 33% |
| Provincial Marginal Tax Rate | 7% | 14% | 21% |

In 2018, their father and mother were killed in a parachuting accident. Their will leaves all of their assets to their three daughters to be shared equally. While it will take some time for their estate to be completely settled, the trustee was able to distribute cash of $300,000 during 2018.

Each of the sisters intends to invest their $100,000 share of the distribution on January 1, 2019. They are considering the following two alternatives:

**Corporate Bonds** Corporate bonds that provide a 6 percent coupon rate. These bonds can be purchased at their maturity value. They mature in 12 years.

**Common Stock** The common shares are available at a price of $50 per share. These shares pay a well established annual eligible dividend of $3.25 per share.

The income from these investments would not move any of the three sisters to a higher federal or provincial tax bracket. The provincial dividend tax credit on eligible dividends is equal to 25 percent of the dividend gross up. Each sister already has sufficient income to use all of her available tax credits.

**Required:** Advise each of the Brock sisters as to which investment they should make. As part of your recommendation, calculate the after tax return that would be generated for each of the sisters, assuming that they invested their $100,000 in:

A. the corporate bonds.
B. the common stock.

Comment on any other factors that they should consider in making their choice.

## Assignment Problem Seven - 5

### (Investments In Income Trusts And Common Stock)

On January 1, 2019, Carolyn Jackson received a $200,000 inheritance from her mother. While she has no plans to use any of these funds during 2019, she and her three sisters plan to open a bed and breakfast in a year and she will need the funds to purchase her share of the business on January 1, 2020.

In the meantime, she would like to invest the $200,000 for a one year period. She is considering the following investments and would like your advice on the appropriate choice:

**Reel Estate Income Trust** On January 1, 2019, this trust is selling for $25 per unit. It makes a distribution of $0.10 per unit per month. This distribution includes a return of capital of $0.01 per month, with the balance of the distribution being property income. Carolyn will sell the units at the end of 2019. She anticipates that these units will be selling for at least $26 per unit at that time.

**Ventex Inc. Common Stock** On January 1, 2019, the shares of this public company are selling for $80 per share. The Company pays an annual eligible dividend of $3.00 per share. Carolyn anticipates that these shares will be selling for at least $85.00 per share on December 31, 2019.

During 2019, Carolyn will continue to work at her present job. Her employment income is such that any additional income will be taxed at a combined federal/provincial rate of 32 percent. Carolyn lives in a province where the provincial dividend tax credit for eligible dividends is equal to 30 percent of the gross up.

**Required:** Write a brief memorandum providing investment advice to Carolyn.

## Assignment Problem Seven - 6

### (Business And Property Income)

Mr. Sonny Shark is an accountant who has a well established practice in Edmonton. He uses the billed basis of income recognition.

Relevant information on his practice for the taxation year ending December 31, 2019, is as follows:

| | |
|---|---|
| December 31, 2018 Unbilled Work In Progress | $ 42,000 |
| December 31, 2019 Unbilled Work In Progress | 35,000 |
| Billable Hours (1,900 Hours At $250 Per Hour) | 475,000 |
| Office Supplies And Office Expenses | 56,000 |
| Travel Costs Other Than Meals And Entertainment | 8,000 |
| Business Meals And Entertainment | 12,000 |

Mr. Shark purchased the building in which his practice is located in 2004. His practice uses 50 percent of the floor space in the building and, on January 1, 2019 the Class 1 UCC for the building is $526,000.

Since the building was purchased, the other one-half of the building had been rented to a very successful lawyer who was paying rent of $4,000 per month. This lawyer was convicted of embezzling from his clients and was jailed on July 1, 2019. Despite all his efforts, Mr. Shark could not find a new tenant and received rent for only six months during 2019.

The 2019 interest, taxes, and other expenses (other than CCA) that can be allocated to the one-half of the building that was rented total $14,400.

Mr. Shark owns the furnishings in his office. The cost of these furnishings was $24,000 and, on January 1, 2019, the Class 8 UCC for these furnishings is $11,059.

Mr. Shark is an avid investor in the stock market. During 2019, he received eligible dividends totaling $18,000. He did not dispose of any shares during the year.

**Required:** Determine Mr. Shark's minimum Net Income For Tax Purposes for the year ending December 31, 2019. Ignore GST considerations and the need to make CPP contributions by Mr. Shark.

### *Assignment Problem Seven - 7*

***(Foreign Property Income, Income Trusts And Mutual Funds)***

Late in 2018, Ms. Betsy Cheung receives $1,000,000 in cash in settlement of her mother's estate. On January 1, 2019, she invests the funds as follows:

**Mutual Fund Units** She acquires 4,000 units of Benson Small Cap, a mutual fund trust, at a price of $15 per unit. During 2019, the trust makes a distribution of $1.40 per unit. The composition of this distribution is as follows:

| | |
|---|---|
| Capital Gains | $0.50 |
| Eligible Dividends | 0.70 |
| Interest | 0.20 |
| Total Per Unit | $1.40 |

Betsy reinvests this distribution in new Benson Small Cap units at $16.50 per unit. She is still holding these units at the end of 2019.

**Income Trust Units** Betsy acquires 14,000 units of Canfor Properties, a real estate income trust. The units are acquired at a cost of $6.00 per unit. During 2019, the trust makes a distribution of $0.60 per unit. Of this total, $0.25 represents a return of capital, with the balance being property income. The proceeds of this distribution are invested in additional Canfor units at a cost of $6.75 per unit. She is still holding these units at the end of 2019.

**Foreign Term Deposit** Betsy acquires a Swiss franc denominated term deposit with a maturity value of 300,000 Swiss Francs (SF, hereafter). The Canadian dollar cost is C$387,000. On December 31, 2019, the principal amount of the term deposit is paid, along with interest of SF15,000. Foreign tax authorities withhold 20 percent of the interest. Assume that throughout 2019, SF1 = $1.29.

**Public Company Shares** Betsy acquires 3,000 shares of BDE at a cost of $30 per share. During 2019, the shares pay her eligible dividends of $1.70 per share. On December 1, 2019, the shares are sold for $31.50 per share.

**CCPC Shares** Betsy acquires 2,100 shares in her mother's Canadian controlled private company at a price of $65 per share from her estate. During 2019, these shares pay her non-eligible dividends of $3.50 per share. She is still holding these shares at the end of 2019.

Betsy has other income that places her in the 33 percent federal tax bracket and 18 percent provincial tax bracket for any additional income. Taxes on that income are sufficient to use all of her available tax credits before considering the effects of the investments purchased with her inheritance. She lives in a province where the dividend tax credit on eligible dividends is 32 percent of the gross up, and on non-eligible dividends is 20 percent of the gross up.

**Required:** Calculate the amount of Taxable Income and Tax Payable that will result from the dispositions and distributions of her investments. In addition, indicate the per unit adjusted cost base for each of the two trust units on December 31, 2019. Ignore any tax implications resulting from international tax treaties.

### *Assignment Problem Seven - 8*

#### *(Comprehensive Case Covering Chapters 1 to 7)*

Carl Nemah is 66 years old and while he receives significant pension income from a former employer's RPP, he is a full time employee of Jardu Enterprises Ltd. (JEL). During 2019, his gross wages were $62,000. JEL withheld the following amounts from these wages:

| | |
|---|---|
| RPP Contributions | $3,125 |
| EI Premiums | 860 |
| CPP Contributions | 2,749 |
| Union Dues | 572 |
| United Way Contributions | 2,400 |

During 2019, his pension receipts totaled $42,000. He has not applied for OAS as he knows that all of it will be clawed back. Further, he has not applied for CPP as he is aware that deferring this application will result in larger benefits.

Carl has been married to Susan Nemah, for over 40 years. Susan is 68 years old and has Net Income For Tax Purposes of $9,900. This consists of OAS payments of $7,400 and pension income from her RRSP. She has not applied for CPP.

Carl has two children. His 32 year old son Jerome has been blind since birth. He lives with and is totally dependent on Carl and Susan. He has no income of his own.

Carl's daughter Suzanne is 41 years old and is recently divorced. She and her children also live with Carl. Her only income is $36,000 in child support that she receives under a 2017 court decree. In 2019, she decided to become an accountant and, to this end, she began attending university on a full time basis in September. Carl has paid her tuition of $4,600 for 2019 and Suzanne has agreed to transfer any tuition credit available to her father.

The family's medical expenses, all of which have been paid by Carl, are as follows:

| | |
|---|---|
| Carl | $ 600 |
| Susan | 1,100 |
| Jerome | 12,250 |
| Suzanne | 1,400 |
| Total Medical Expenses | $15,350 |

During 2019, Carl received the following dividends (all amounts in Canadian dollars):

| | |
|---|---|
| Eligible Dividends From Taxable Canadian Corporations | $11,700 |
| Non-Eligible Dividends On Shares In His Sister's CCPC | 3,250 |
| Dividends On Foreign Shares - Net Of 15 Percent Withholding | 10,625 |
| Total Dividends Received | $25,575 |

In addition to dividends, Carl had 2019 interest income of $2,843.

Because of the project management skills that he has acquired over the years, Carl started a management consulting business in 2016. In that year he acquired a new building to be used as an office for his business. The building cost $426,000 of which $126,000 was the estimated value of the land. On January 1, 2019, the UCC of the building is $273,540.

The building contains office furniture and fixtures that were acquired at a cost of $42,000. On January 1, 2019, they have a UCC of $30,240.

During 2019, he spends $41,000 on improving and upgrading the building. In addition, he sells the old furniture and fixtures for $18,600 and acquires replacement furniture and fixtures for $50,000.

As Carl has no reason to keep detailed accounting records, he records business income on a cash basis. For 2019, his net cash flow from operations was $123,500. Relevant figures for the beginning and end of 2019 are as follows:

| | January 1 | December 31 |
|---|---|---|
| Billed Receivables | $13,400 | $17,350 |
| Unbilled Work In Process | 17,470 | 21,250 |
| Accounts Payable | 8,670 | 9,272 |

Since the inception of the business, Carl has owned a car that is used 100 percent for business activity. The car that he acquired in 2016 was sold in 2018. He acquired a new car on January 1, 2019 at a cost of $61,500. He financed the car through his bank and, during 2019, he made payments of $13,200 on the loan. All of this amount was deducted in determining his net cash flow from operations. Of the total, $4,920 represented payments for interest. Carl paid car operating costs totalling $9,260 during 2019.

**Required**: Calculate Carl's 2019 minimum Net Income For Tax Purposes, his 2019 minimum Taxable Income, and his 2019 minimum federal Tax Payable. Ignore GST/HST/PST considerations and the possibility of pension income splitting.

### *Assignment Problem Seven - 9*

#### *(Comprehensive Case Covering Chapters 1 to 7)*

Ms. Jezebel Forest is 67 years old and has been married to the same man, Bernard Forest, for over 40 years. She has never applied for OAS as she knows that, for the foreseeable future, it will all be clawed back. In addition, she has not applied for CPP as she is aware that deferring the application will result in larger benefits. She has elected to continue contributing to the CPP.

She has been employed by a number of organizations over her working life and, during 2019, she receives pension income from various RPPs totalling $4,000 per month.

Currently, she is a full time employee of Dartmor Enterprises Ltd. with an annual salary of $71,500. Dartmor withheld the following amounts from this salary:

| | |
|---|---|
| RPP Contributions | $2,500 |
| EI Premiums | 860 |
| CPP Contributions | 2,749 |
| Union Dues | 336 |
| Annual United Way Contributions | 1,800 |

Jezebel's spouse, Bernard Forest is 69 years old and has Net Income For Tax Purposes of $15,200. This consists of pension income from his RRSP and OAS payments. He has not applied for CPP.

The couple have two children. Their 42 year old daughter Samantha has been blind since an automobile accident when she was a teenager. She lives with Jezebel and Bernard, is totally dependent on them, and has no income of her own.

Their 44 year old son Norman has had a long history of substance abuse. However, he is currently living with Jezebel and Bernard and is in a rehabilitation program that seems to be working. The program provides him with a monthly income of $2,000, conditional on his staying enrolled in a university program leading to an accounting degree. During 2019, he attends university on a full time basis for 10 months. His tuition fees are $11,300 and he has textbook costs of $1,100. Jezebel pays all of these costs and Norman has agreed to transfer any unused education credits to her. Norman's only tax credits are his basic personal credit and education related credits.

During 2019, Jezebel received the following dividends (all amounts in Canadian dollars):

| | |
|---|---|
| Eligible Dividends From Taxable Canadian Corporations | $15,400 |
| Non-Eligible Dividends On Shares In Her Sister's CCPC | 2,600 |
| Dividends On Foreign Shares - Net Of 15 Percent Withholding | 13,600 |
| Total Dividends Received | $31,600 |

In addition to dividends, Jezebel had 2019 interest income of $1,456.

The family's medical expenses, all of which have been paid by Jezebel, are as follows:

| | |
|---|---|
| Jezebel | $ 450 |
| Bernard | 1,475 |
| Samantha | 11,400 |
| Norman | 8,470 |
| Total Medical Expenses | $21,795 |

Jezebel also operates a management consulting business which she started in 2016. In that year, she acquired a building to be used exclusively as an office for this business. The building cost $383,000, of which $112,000 reflects the value of the land on which the building is situated. On January 1, 2019, the UCC of the building is $232,272. This is the only building owned by Jezebel other than her principal residence.

When she acquired the building in 2016, she also acquired office furniture and fixtures at a cost of $18,500. On January 1, 2019, the UCC of these assets is $10,656.

During 2019, Jezebel spends $23,500 in improvements to the building and $24,500 on new furniture and fixtures. The older furniture and fixtures are sold for $6,200.

As this business has expanded, on January 1, 2019, Jezebel acquires an automobile to be used exclusively in the business. The cost of the car is $41,500, all of which was financed with a bank loan. During 2019, interest charges on the bank loan total $4,980, all of which was deducted in determining the cash flows from operating the business. The 2019 operating costs for the vehicle totaled $5,600.

As Jezebel has no reason to keep detailed accounting records, she records business income on a cash basis. For 2019, her net cash flow from operations was $96,400. Relevant figures for the beginning and end of 2019 are as follows:

| | **January 1** | **December 31** |
|---|---|---|
| Billed Receivables | $8,400 | $11,250 |
| Unbilled Work In Process | 12,600 | 18,400 |
| Accounts Payable | 6,240 | 7,485 |

**Required**: Calculate Jezebel's 2019 minimum Net Income For Tax Purposes, her 2019 minimum Taxable Income, and her 2019 minimum federal Tax Payable. Ignore GST/HST/PST considerations and the possibility of pension income splitting.

# CHAPTER 8

# Capital Gains And Capital Losses

## Economic Background

### Capital Assets And Income Taxation Policy

8-1. Capital gains and losses result from the disposition of assets that are being, or have been, used to produce business or property income. As such, they are viewed as a separate category of income. They are not included in the determination of either business or property income and, in general, these gains and losses will be incidental to the ongoing activities that produce business or property income. Given this, a case can be made for exempting this type of income from taxation.

8-2. This case is reinforced during periods of high inflation. If a business is going to continue operating as a going concern, it will usually have to replace any capital assets that are sold. As gains on the sale of capital assets often reflect nothing more than inflationary price increases, such gains cannot be distributed to the owners of the business, as they must be used to finance the replacement of the assets sold.

8-3. Until 1972, Canadian tax legislation did not levy any income tax on capital gains. One of the most significant changes in the 1972 tax reform legislation was the introduction of taxation on capital gains, as the government believed that the ability to completely escape taxation on this type of income was creating severe inequities in the taxation system.

8-4. The capital gains taxation that became effective January 1, 1972, represented a compromise between the view that capital gains should be exempt from tax and the position that such freedom from taxation creates serious inequities among various classes of taxpayers. Taxation of capital gains was introduced, but on a basis that was very favourable to the taxpayer.

8-5. In simple terms, the 1972 rules indicated that one-half of a capital gain would be treated as a taxable capital gain and, similarly, one-half of a capital loss would be deductible against capital gains as an allowable capital loss. This meant that for an individual taxpayer in the 45 percent tax bracket, the effective tax rate on capital gains was an attractive 22.5 percent.

### Lifetime Capital Gains Deduction

8-6. Even though capital gains taxation was applied in a very favourable manner, there was a continuing view that any taxation of such income was not appropriate. As a reflection of this

view, in 1985, the government introduced the lifetime capital gains deduction. The original legislation provided that every Canadian resident could enjoy tax free treatment of up to $500,000 of capital gains on the disposition of any type of capital asset. From its introduction, this provision was heavily criticized as a gift to higher income Canadians, particularly in view of the fact that it was available on any type of capital gain. It was difficult for many analysts to see the economic justification for providing favourable tax treatment of gains on the sale of a wealthy Canadian's Florida condominium.

8-7. As a result of such criticism, a variety of limitations was introduced over subsequent years. Without going through a detailed history of these changes, we would note that, as of 2019, a deduction is available for the taxable part of an $866,912 capital gain resulting from the disposition of shares of a qualified small business corporation. Even more attractive is the availability of a deduction for the taxable component of a $1,000,000 capital gain on the disposition of a qualified farming or fishing property.

8-8. It should be noted here that the provisions related to the lifetime capital gains deduction do not affect any of the material in this Chapter. The lifetime capital gains legislation did not alter the determination of the amount of taxable capital gains to be included in Net Income For Tax Purposes. Rather, the legislation provided for a deduction in the determination of Taxable Income for all or part of the taxable capital gains included in Net Income For Tax Purposes. This material is covered in Chapter 11, Taxable Income And Tax Payable For Individuals Revisited.

### Changes In The Inclusion Rate

8-9. For gains and losses on capital assets disposed of subsequent to October 17, 2000, the inclusion rate has been one-half. Prior to that time, the rate was variously set at two-thirds (1988, 1989, and part of 2000) or three-fourths (1990, through February, 2000). There are a very limited number of situations in which these alternative inclusion rates are still relevant. However, we do not believe such situations are of sufficient interest to warrant coverage in a general taxation text.

8-10. Given this situation, very little coverage of these rates will be included in either the text or the related problems.

## General Rules

### Capital Gains In The *Income Tax Act*

8-11. The material in this Chapter is a continuation of our discussion of the calculation of Net Income For Tax Purposes. In Chapter 3, detailed attention was given to employment income. In terms of the *Income Tax Act*, this discussion was based on Subdivision a of Division B of the *Act*. Chapters 5, 6, and 7 dealt with Subdivision b of Division B and provided a comprehensive consideration of both business and property income. This included detailed coverage of the calculations related to capital cost allowance (CCA), an important deduction in the determination of both business and property income.

8-12. Capital gains and losses are the third major component of Net Income For Tax Purposes. This subject is covered in Subdivision c of Division B, Sections 38 through 55. Sections 38 and 39 define taxable capital gains, allowable capital losses, and other items that relate to the calculation of these amounts. Section 40 provides the general tax rules for computing these amounts. The remaining Sections 41 through 55 deal with more specific matters, such as identical properties (Section 47), adjustments to the cost base (Section 53), and various additional definitions (Section 54).

### Capital Gains Defined

#### *Capital Assets*

8-13. In general, capital gains can occur when a taxpayer disposes of a capital asset. You will recall that capital assets were described in Chapter 6 as being those assets that are capable

of earning income in the form of business profits, interest, dividends, royalties, or rents. This means that the assets must be held for this income producing purpose, rather than for a quick resale at a profit.

8-14. It was also noted in Chapter 6 that determining whether an asset was capital in nature was sometimes difficult, resulting in frequent litigation on this issue. That Chapter contained a fairly extensive discussion of the factors that the courts take into consideration in determining the nature of a particular asset. These factors included the intent and course of the taxpayer's conduct, the number and frequency of transactions involving the type of asset under consideration, the length of the ownership period, the nature of the asset, and the relationship of the asset to the business of the taxpayer.

### Capital Gains Election On Canadian Securities

8-15. In the case of equity securities, it is often difficult to distinguish between those situations where a taxpayer is holding the securities in order to earn dividend income or, alternatively, holding the securities in order to generate a gain on their ultimate disposition. Fortunately, the *Income Tax Act* provides an election, which keeps this issue out of the courts.

8-16. ITA 39(4) allows taxpayers, including corporations and trusts, to elect to have all Canadian securities that they own deemed to be capital property, and all sales of such securities deemed to be dispositions of capital property. Once this election is made, it cannot be revoked and it applies to all future dispositions of Canadian securities by the taxpayer, thus assuring the taxpayer that all gains will be treated as favourably taxed capital gains. The downside of this election is that, if a taxpayer experiences a loss on the disposition of securities, it must be treated as a capital loss, only one-half of which is deductible.

8-17. ITA 39(5) indicates that this election is not available to traders or dealers in securities, financial institutions, a corporation in the business of lending money or purchasing debt obligations, or non-residents.

## Dispositions

### Actual Dispositions

8-18. The definition of "disposition" in ITA 248(1) states that, in general, a disposition is any transaction or event that entitles a taxpayer to "proceeds of disposition" (see Paragraph 8-24 for an explanation of this term). The most obvious such transaction would be a simple sale of property for cash. However, as listed in this definition, there are many other transactions and events that would be considered dispositions for income tax purposes. The more common of those listed would be:

- sales of property;
- redemptions of debt securities or shares;
- cancellations of debt securities or shares;
- expirations of options;
- expropriations of capital property;
- destruction of property through natural or other causes; and
- conversions of debt or shares.

8-19. In general, transfers of capital assets are not considered to involve a disposition unless there is a change in beneficial ownership. For example, a transfer of property between two trusts with identical beneficiaries would not be considered a change in beneficial ownership and, as a result, the transfer would not be treated as a disposition. An exception to this general rule occurs when there is a transfer to an RRSP. Even though there is no change in beneficial ownership, the transfer would be treated as a disposition of the transferred asset.

### Gifts

8-20. A gift between taxpayers generally involves a transfer of beneficial ownership. While gifts are not one of the examples listed in the ITA 248(1) description of a disposition, from a legal perspective it is clearly a disposition. In the absence of a special provision, the proceeds

of disposition for a gift would be nil. However, in this situation, ITA 69 kicks in, deeming the proceeds of disposition for the gift to be the fair market value of the property transferred.

8-21. While most gifts are made to non-arm's length taxpayers, the ITA 69 provision cited in the preceding paragraph applies to any gift, without regard to whether the recipient is at arm's length with the person making the gift. This means that any taxpayer that has made a gift will be deemed to have proceeds equal to the fair market value of the gifted property.

8-22. ITA 69 also indicates that where a taxpayer acquires a property by way of a gift, that taxpayer is deemed to have acquired the property at its fair market value.

### Deemed Dispositions

8-23. In addition to actual dispositions of capital property, there are a number of situations in which a disposition is deemed to have occurred. That is, even though there is no actual disposition, rules in the *Income Tax Act* require that, when certain events occur, the taxpayer must assume that a disposition and immediate re-acquisition of specified capital properties has occurred. In this Chapter we will give consideration to deemed dispositions that result from a change in the use of a property and deemed dispositions that occur when an individual departs from Canada. Deemed dispositions that arise on the death of a taxpayer will be covered in Chapter 9.

## Proceeds Of Disposition

### Actual Proceeds Of Disposition

8-24. The term, "proceeds of disposition", is defined in ITA 54 and ITA 13(21). Included in both of these definitions are the following:

- The sale price of property sold.
- Compensation for property unlawfully taken or for property destroyed, including related proceeds from insurance policies.
- Compensation for property that has been appropriated or injuriously affected whether lawfully or unlawfully.
- Compensation for damaged property, including amounts payable under insurance policies.

### Deemed Proceeds Of Disposition

8-25. Deemed proceeds of disposition can arise in two different ways. When there is a deemed rather than an actual disposition, the legislation that requires the deemed disposition will specify how the deemed proceeds of disposition will be determined. For example, when there is a deemed disposition for an individual departing from Canada, the deemed proceeds of disposition will generally be the fair market value of the relevant asset.

8-26. There are other situations in which there is an actual disposition, with the *Income Tax Act* requiring the use of a deemed proceeds that is different from the actual proceeds. For example, if there is a non-arm's length transfer and the proceeds of disposition are below the fair market value of the relevant assets, ITA 69 deems the proceeds to be fair market value.

## Adjusted Cost Base

### Definition

8-27. The adjusted cost base of an asset is defined in ITA 54 as follows:

(i) where the property is depreciable property of the taxpayer, the capital cost to him of the property as of that time, and

(ii) in any other case, the cost to the taxpayer of the property adjusted, as of that time, in accordance with Section 53.

8-28. This definition means that, in general, the adjusted cost base of a capital asset is analogous to the accounting concept of historical cost. As with the GAAP approach to historical cost, it includes the invoice cost, delivery and setup charges, non-refundable provincial sales taxes, non-refundable GST/HST, and any other costs associated with acquiring the asset, or putting it into use.

8-29. As indicated in the adjusted cost base definition, ITA 53 specifies a number of adjustments to the cost base. Some of the more important of these adjustments can be described as follows:

**Government Grants And Assistance** When a taxpayer receives government grants or other types of assistance, these amounts are generally deducted from the adjusted cost base of the related asset. This is consistent with the accounting treatment of government grants under GAAP.

**Superficial Losses** A superficial loss occurs when a taxpayer disposes of a property and:

- within the period of 30 days before the disposition or 30 days after the disposition, the taxpayer or his spouse or common-law partner acquires the same property (referred to as the substituted property), and,
- at the end of the period (60 days), the taxpayer or his spouse or common-law partner owns the substituted property.

Any loss on the disposition of the original property is called a superficial loss. Such losses cannot be deducted, but must be added to the adjusted cost base of the substituted property.

As an example, assume that in 2015 Ms. Deffett acquires 100 shares of Norton Limited for $75 per share. On December 27, 2019 the shares are trading at $60 and, because she has realized capital gains in 2019, Ms. Deffett sells the shares on this date in order to realize a loss that can be used to offset the capital gains. One-half of the capital loss of $15 per share on the December 27, 2019 sale would be deductible, provided no Norton Limited shares are purchased between November 27, 2019 and January 26, 2020. If, however, she was to purchase 100 Norton shares on December 15, 2019 or January 15, 2020 for $65 per share, the December, 2019 loss would be disallowed. The disallowed loss would be added to the adjusted cost base of the new shares, giving these shares an adjusted cost base of $80 ($65 + $15) per share. This amount would be appropriate in that it reflects her net cash outlay per share ($75 - $60 + $65).

**Stock Option Benefit** When shares are acquired through the exercise of stock options, the adjusted cost base of the shares is increased by the amount of any employment income benefit that is recorded at the time of acquisition. In effect, the adjusted cost base of the shares is written up to their fair market value at the time of exercise. (See Chapter 3, Employment Income, for coverage of stock options.)

**Other Adjustments To The Cost Base** Other important adjustments would include the addition of undeducted interest and property taxes on vacant land to the adjusted cost base (only available if the land is used in a business and held primarily to produce income), the addition of subsequent capital contributions by a shareholder to a corporation to the cost base of the shares, and the requirement that under certain circumstances, forgiveness of debts on property must be deducted from the cost base of that property.

8-30. There are several other such adjustments in ITA 53. You should note, however, that in the case of depreciable property, any deductions taken for CCA do not change the adjusted cost base of the property. Capital gains are determined on the basis of the original capital cost of the asset, not the UCC.

## Exercise Eight - 1

**Subject:** Government Assistance

On January 1, 2019, Rotan Ltd. acquires real property at a cost of $5,600,000. Of this amount, $600,000 represents the fair market value of the land. The building is new and will be used 100 percent for non-residential activity, none of which involves manufacturing. Rotan allocates its cost to a separate Class 1. In order to encourage Rotan's move to this location, the local government has given them $1,500,000 to assist in the acquisition of the building. What is the maximum amount of CCA that Rotan can deduct on this building for its fiscal year ending December 31, 2019?

## Exercise Eight - 2

**Subject:** Superficial Loss

Ms. Nadia Kinski owns 1,000 shares of Bord Ltd. They have an adjusted cost base of $23 per share. On August 20, 2019, she sells all of these shares at $14.50 per share. On August 25, 2019, she acquires 600 shares of Bord Ltd. at a cost of $13.75 per share and is still holding the shares at the end of the year. What are the tax consequences of these transactions?

**SOLUTIONS available in print and online Study Guide.**

### *Negative Adjusted Cost Base*

8-31. It is possible that sufficient adjustments could be made to an adjusted cost base that its balance will become negative. When this occurs, ITA 40(3) requires that the deficiency be treated as a capital gain and the adjusted cost base of the asset be adjusted to nil. Note that, unlike the situation with recapture of CCA, this would apply even if additions to the cost base prior to the end of the taxation year were sufficient to eliminate the deficit balance.

8-32. Also note that ITA 40(3) is not applicable to most partnership interests. That is, a negative adjusted cost base for a partnership interest does not automatically trigger a capital gain and can be carried forward indefinitely. However, this exemption from ITA 40(3) does not apply to limited partners or certain inactive partners. For more details on this point, see Chapter 18, Partnerships.

### *GST/HST/PST Considerations*

8-33. A business will pay GST, HST, or PST on most of the capital assets that it acquires. As is discussed in more detail in Chapter 21, all or part of the amounts paid can be refunded under certain circumstances. From a technical point of view, all amounts of GST/HST/PST are, at least initially, included in the capital cost of depreciable assets. However, to the extent that these amounts are refunded as input tax credits, they are defined in ITA 248(16) as a form of government assistance and, as a consequence, the refunds are deducted from the capital cost of depreciable assets in the same manner as other government assistance. In effect, this means that GST/HST/PST amounts that are refunded are not included in the capital cost of depreciable assets.

## Calculating The Capital Gain Or Loss

8-34. The general formula for determining the amount of a capital gain or loss can be described very simply. The calculation, using assumed data, is as follows:

| | | |
|---|---|---|
| Proceeds Of Disposition | | $4,750 |
| Less - The Aggregate Of: | | |
| Adjusted Cost Base | ($3,890) | |
| Expenses Of Disposition | ( 560) | ( 4,450) |
| Capital Gain (Loss) | | $ 300 |
| Inclusion Rate | | 1/2 |
| Taxable Capital Gain (Allowable Capital Loss) | | $ 150 |

8-35. If, as in the preceding example, there is a capital gain, one-half of the amount will be treated as a taxable capital gain. The adjective "taxable" is consistently used to indicate the portion of the total gain that will be included in income. Similarly, one-half of a negative amount (a capital loss) resulting from the application of the preceding formula would be treated as an allowable capital loss. The adjective "allowable" is consistently used to indicate the deductible portion of the total amount of the loss.

8-36. In Chapter 1, we noted that ITA 3 specifies that Net Income For Tax Purposes includes the amount, if any, by which taxable capital gains exceed allowable capital losses. At that point, we noted that the use of the phrase "if any" establishes the rule that current year allowable capital losses can only be deducted to the extent that there are current year taxable capital gains.

# Detailed Application Of The Rules

## Identical Properties

8-37. A taxpayer can own a group of identical properties that have been acquired over a period of time at different costs. This would arise most commonly with holdings of securities such as common stock in a particular corporation. If part of such a group of assets is disposed of, ITA 47 requires that the adjusted cost base for the assets being disposed of be based on the average cost of the entire group.

8-38. The following example illustrates the application of the identical property procedures, other than the procedures applicable to shares acquired through stock options:

**EXAMPLE** An individual has engaged in the following transactions involving the common stock of Gower Company, a Canadian public company:

| Acquisition Date Or Sale Date | Shares Purchased (Sold) | Cost Per Share | Total Cost | Average Cost/Share |
|---|---|---|---|---|
| 2005 | 4,000 | $10.00 | $ 40,000 | |
| 2006 | 3,000 | 12.00 | 36,000 | |
| Subtotal | 7,000 | | $ 76,000 | $10.86 |
| 2009 | ( 2,000) | $10.86 | ( 21,720) | |
| Subtotal | 5,000 | | $ 54,280 | $10.86 |
| 2012 | 2,500 | $11.00 | 27,500 | |
| 2017 | 3,000 | 10.00 | 30,000 | |
| Subtotal | 10,500 | | $111,780 | $10.65 |
| 2019 | ( 1,500) | $10.65 | ( 15,975) | |
| End Of Year Balances | 9,000 | | $ 95,805 | $10.65 |

The 2,000 units sold in 2009 were sold for $10 per unit. The 1,500 units sold in 2019 were sold for $13 per unit.

**ANALYSIS** Using the information from the preceding table, the 2009 allowable capital loss is calculated as follows:

| | |
|---|---|
| Proceeds Of Disposition [(2,000)($10)] | $20,000 |
| Adjusted Cost Base [(2,000)($10.86)] | ( 21,720) |
| Capital Loss | ($ 1,720) |
| Inclusion Rate | 1/2 |
| Allowable Capital Loss | ($ 860) |

The 2019 taxable capital gain would be calculated as follows:

| | |
|---|---|
| Proceeds Of Disposition [(1,500)($13)] | $19,500 |
| Adjusted Cost Base [(1,500)($10.65)] | ( 15,975) |
| Capital Gain | $ 3,525 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain | $ 1,763 |

## Exercise Eight - 3

**Subject:** Identical Properties

Ms. Chantal Montrose makes frequent purchases of the common shares of Comco Inc. During 2018, she purchased 650 shares at $23.50 per share on January 15, and 345 shares at $24.25 per share on March 12. She sold 210 shares on September 15, 2018 at $25.50 per share. On February 14, 2019, she purchases an additional 875 shares at $26.75 per share and, on October 1, 2019, she sells 340 shares at $29.50 per share. Determine Ms. Montrose's taxable capital gains for 2018 and 2019.

**SOLUTION available in print and online Study Guide.**

**We suggest you work Self Study Problem Eight-1 at this point.**

## Partial Dispositions

8-39. In those situations where a taxpayer disposes of part of a property, ITA 43 requires that a portion of the total adjusted cost base be allocated to the disposition on a reasonable basis.

**EXAMPLE** A 500 hectare tract of land has an adjusted cost base of $6,000,000. During the current year, 200 of these hectares were sold.

**ANALYSIS** It would appear to be reasonable to allocate $2,400,000, or 40 percent (200 hectares ÷ 500 hectares), of the total adjusted cost base to the land that was sold. If, however, there was some reason that the part of the tract sold had a value that was not proportionate to the total tract, some alternative basis of allocation could be used.

## Warranties On Capital Assets

8-40. If a taxpayer disposes of capital property and the proceeds include some payment for a warranty or other contingent obligation, ITA 42 requires that the full proceeds must be used in determining the capital gain. Stated alternatively, no reserve can be established to provide for any future obligations. However, one-half of any outlays related to such contingent obligations that are made in a subsequent year can be deducted as allowable capital losses, but only against taxable capital gains. Any undeducted losses are subject to the carry over provisions described in Chapter 11.

8-41. You will recall that there was some discussion of warranties in Chapter 6, Business Income. More specifically, we noted there that under ITA 20(1)(m.1), it was possible to deduct the cost of warranties provided by arm's length parties from business income.

However, for most product warranties, the situation is similar to the treatment of warranties on capital assets in that the estimated warranty costs can only be deducted when incurred, not deducted from the proceeds of the asset sale. Note, however, there is a difference in that warranty costs related to the sale of a capital asset will create a capital loss when incurred, rather than a 100 percent deductible business loss.

## Exercise Eight - 4

**Subject:** Warranties On Capital Assets

During the taxation year ending December 31, 2018, Vivid Ltd. sells a capital asset with an adjusted cost base of $237,000 for proceeds of $292,000. The Company provides the purchaser with a one year warranty and the Company estimates that it will cost $4,500 to fulfill the warranty provisions. On October 1, 2019, the Company spends $4,800 to fulfill the warranty provisions. Determine the effect of these transactions on Net Income For Tax Purposes for 2018 and 2019.

**SOLUTION available in print and online Study Guide.**

**We suggest that you work Self Study Problem Eight-2 at this point.**

## Capital Gains Reserves

### *General Principles*

8-42. In some cases, a capital asset disposition may involve debt as a component of the proceeds of disposition. For example, assume Mr. Filoso sold a piece of land for a capital gain and collected only 10 percent of the total proceeds in the year of sale. In such cases, it would seem reasonable to allow him to defer recognition of a part of the capital gain. This deferral can be accomplished through the establishment of a capital gains reserve.

8-43. The general idea is that a reserve can be deducted from the total gain when not all of the proceeds are receivable in the year of the sale. The reserve would reflect the portion of the gain that is contained in the uncollected proceeds. As with other reserves, this amount must be added back to the following year's income, with a new reserve deducted to reflect any remaining uncollected proceeds. Note that the reserve is based solely on the principal amount of the debt. Accrued interest is not included in the reserve calculations.

8-44. In order to use this elective provision, individuals must file Form T2017. Other taxpayers are not required to submit this form and can simply make this election in their return of income.

8-45. At one point in time, the deductible reserve was simply based on the portion of the proceeds of disposition that were not yet received. If a taxpayer collected only 10 percent of the proceeds, the reserve could be equal to 90 percent of the gain. It appears that this provision was being used for what the government viewed as excessive deferrals and, as a consequence, ITA 40(1)(a)(iii) limits the reserve to the lesser of two amounts.

8-46. The first of these two amounts is referred to in the *Act* as a "reasonable amount". While the *Act* does not provide a formula for this "reasonable amount", it refers to amounts that are payable after the end of the taxation year. This can be expressed as follows:

$$\left[\begin{array}{c}\text{Total}\\ \text{Gain}\end{array}\right]\left[\frac{\text{Proceeds Not Receivable Until After End Of Current Taxation Year}}{\text{Total Proceeds Of Disposition}}\right]$$

8-47. The second amount uses a formula that ensures that the maximum reserve will decline by at least 20 percent each year, going from a maximum of 80 percent of the gain in the year of disposition to nil in the fourth year after the disposition. The formula is as follows:

{[Total Gain] [20%] [4 - (Number of preceding taxation years ending after the disposition)]}

8-48. Under this formula, a minimum of 20 percent of the gain must be recognized in the year of the sale and each of the following four years. This prevents a reserve from being used to defer taxation for longer than 4 years. If the proceeds are collected faster than 20 percent per year, the reserve will be based on the actual uncollected proceeds as per the formula in Paragraph 8-46.

8-49. While this reserve is similar to the ITA 20(1)(n) reserve for uncollected amounts described in Chapter 6, the circumstances when the reserves can be used differ as follows:

> **ITA 20(1)(n) Reserve** Used when there is a sale of an inventory item and part of the proceeds are not due until at least two years after the end of the current taxation year. In addition, this provision restricts the reserve to three years. However, there is no restriction on the amount of the reserve during the years that it is available.
>
> **ITA 40(1)(a)(iii) Reserve** Used when there is a capital asset disposition and all or part of the proceeds are not due until after the end of the current taxation year. In contrast to the reserve being restricted to three years under the provisions of ITA 20(1)(n), ITA 40(1)(a)(iii) allows the reserve to be used for a maximum of five years.

### Example - Outstanding Balance Greater Than Formula Limit

8-50. Assume that during 2019, Mr. Filoso sold a piece of land with an adjusted cost base of $340,000, for total proceeds of $1,000,000, resulting in a capital gain of $660,000 ($1,000,000 - $340,000) and a taxable capital gain of $330,000 [(1/2)($660,000)]. He received only $100,000 of the total amount in cash in 2019 and accepted a $900,000 note payable for the balance. The note is payable at the rate of $100,000 per year beginning in 2020. Interest charged at 5 percent of the outstanding balance is also paid annually.

8-51. As he collected only 10 percent of the total proceeds, the reserve would be 90 percent under the "reasonable amount" component of ITA 40(1)(a)(iii). As a result, the maximum reserve will be based on the second component of the formula, which limits the reserve in the first year to 80 percent of the gain. The maximum reserve would be $528,000, the lesser of:

| | |
|---|---|
| • [($660,000)($900,000 ÷ $1,000,000)] | $594,000 (Reserve) |
| • [($660,000)(20%)(4 - 0)] | $528,000 (Reserve) |

8-52. Applying this formula, the taxable capital gain that will be recognized in 2019 is $66,000 [(1/2)($660,000 - $528,000)]. Note that, despite the fact that Mr. Filoso has only collected 10 percent of the proceeds ($100,000 ÷ $1,000,000), the application of the formula requires that he recognize 20 percent ($66,000 ÷ $330,000) of the total gain.

8-53. In 2020, the $528,000 reserve would have to be added back to income. The new reserve for 2020 would be $396,000, the lesser of:

| | |
|---|---|
| • [($660,000)($800,000 ÷ $1,000,000)] | $528,000 (Reserve) |
| • [($660,000)(20%)(4 - 1)] | $396,000 (Reserve) |

8-54. Adding back the previous year's reserve of $528,000, and deducting the new maximum reserve of $396,000, gives a 2020 capital gain of $132,000. This would result in a net addition to 2020 income of $66,000 [(1/2)($528,000 - $396,000)], or 20 percent of the $330,000 taxable capital gain.

8-55. Based on similar calculations, the maximum reserve in 2021 would be $264,000. This would decline to $132,000 in 2022 and in 2023, no reserve would be available. This would result in $66,000 [(1/2)($132,000)] being added to income each year. The entire $330,000 of the taxable capital gain will have been included in income by the end of 2023. This is despite the fact that, at the end of this five year period, $500,000 of the initial proceeds remains uncollected.

### *Example - Outstanding Balance Less Than Formula Limit*

8-56. In the preceding example, collections of cash were less than 20 percent in all years under consideration. As a result, the application of ITA 40(1)(a)(iii) resulted in the recognition of 20 percent of the gain in each year.

8-57. Situations in which the uncollected portion of the proceeds is greater than the formula limit will result in more than 20 percent of the gain being taxed in a year. As an illustration of this possibility, assume that in the Paragraph 8-50 example, Mr. Filoso collected $250,000 in the year of the disposition, and that the required payments were $75,000 per year for the following ten years.

8-58. Based on this information, the maximum reserve for 2019 would be $495,000, the lesser of:

| | |
|---|---|
| • [($660,000)($750,000 ÷ $1,000,000)] | $495,000 (Reserve) |
| • [($660,000)(20%)(4 - 0)] | $528,000 (Reserve) |

8-59. This means that a taxable capital gain of $82,500 [(1/2)($660,000 - $495,000)] would be recognized in 2019.

8-60. In 2020, the $495,000 reserve would be added back to income. The new reserve for 2020 would be $396,000, the lesser of:

| | |
|---|---|
| • [($660,000)($675,000 ÷ $1,000,000)] | $445,500 (Reserve) |
| • [($660,000)(20%)(4 - 1)] | $396,000 (Reserve) |

8-61. This results in the recognition of a $49,500 [(1/2)($495,000 - $396,000)] taxable capital gain in 2020. At this point, the minimum 20 percent per year recognition requirement has become the determining factor in calculating the capital gain to be included in income. As a consequence, the amount to be included in income in the years 2021, 2022, and 2023 would be as presented in Paragraph 8-55.

## Exercise Eight - 5

**Subject:** Capital Gains Reserves

During December 2018, Mr. Gerry Goodson sells a capital property with an adjusted cost base of $293,000 for proceeds of disposition of $382,000. Selling costs total $17,200. In the year of sale, he receives $82,000 in cash, along with the purchaser's note for the balance of the proceeds. The note is to be repaid at the rate of $60,000 per year beginning in 2019. He receives the 2019 payment in full. Assume that Mr. Goodson deducts the maximum capital gains reserves. Determine his taxable capital gain for 2018 and 2019.

**SOLUTION available in print and online Study Guide.**

**We suggest you work Self Study Problems Eight-3 and Eight-4 at this point.**

## Bad Debts On Sales Of Capital Property

8-62. When an amount receivable results from the disposition of a capital property, the possibility arises that some of the proceeds of disposition will have to be written off as a bad debt. When this occurs, ITA 50(1) allows the seller to elect to have disposed of the receivable and immediately reacquired it at a proceeds and cost of nil. Consider the following:

**EXAMPLE** During 2019, a capital property with a cost of $500,000 is sold for $510,000. The proceeds are made up of $360,000 in cash, plus the purchaser's note for $150,000.

8-63. If the vendor of the capital property does not choose to deduct a capital gains reserve for the uncollected amount, a taxable capital gain of $5,000 [(1/2)($510,000 - $500,000)]

would be recognized in 2019. If, during 2019, the note received from the purchaser turns out to be uncollectible, the deemed disposition and reacquisition would result in an allowable capital loss of $75,000 [(1/2)($150,000)], $5,000 of which would offset the $5,000 taxable capital gain on the disposition. The remaining allowable capital loss of $70,000 ($75,000 - $5,000) would first be applied against any other taxable capital gains that are realized in 2019 with any balance carried over. (Loss carry overs are covered in Chapter 11.) If, at a later point in time, some amount of the debt was recovered, any excess over the deemed nil proceeds would be considered a capital gain.

## Exercise Eight - 6

**Subject:** Bad Debts From Dispositions Of Capital Property

During 2018, a capital property with an adjusted cost base of $125,000 is sold for $110,000. The proceeds of disposition are made up of $75,000 in cash, plus the purchaser's one-year note for $35,000. In 2019, the note proves to be uncollectible. What are the tax consequences of these events in 2018 and in 2019?

**SOLUTION available in print and online Study Guide.**

**We suggest you work Self Study Problems Eight-5 and Eight-6 at this point.**

## Special Rule For Sales Of Real Property

### *The Problem*

8-64. Real property, a.k.a. real estate, is land and all appurtenances to it, such as buildings (although crops and mineral rights would also be included, coverage of these types of assets is beyond the scope of this material). As only the building component qualifies for CCA deductions, it is always necessary to separate these two components. As separate market prices for the two components do not usually exist, this separation requires the use of estimates. As you are likely aware, estimates involve judgment and can vary significantly from expert to expert.

8-65. The problem is that when there is a disposal of real property, the amounts of the proceeds that are allocated to the two components have a significant impact on any resulting Taxable Income. Larger amounts allocated to the land will create or increase a capital gain, only one-half of which is taxable. If this results in smaller amounts being allocated to the building, this could result in a fully deductible terminal loss.

**EXAMPLE** Martin Ltd. has only one Class 1 building. During 2019, the Company disposes of the building and replaces it with a leased property. The following information relates to this disposition:

| | |
|---|---|
| Proceeds Of Disposition Allocation | |
| Land (Estimated Value) | $300,000 |
| Building (Estimated Value) | 110,000 |
| Total Proceeds Of Disposition | $410,000 |
| | |
| Adjusted Cost Base Of Land | $200,000 |
| Original Cost Of Building | 175,000 |
| UCC Class 1 | 150,000 |

8-66. In the absence of a special rule, there would be a $50,000 taxable capital gain on the land [(1/2)($300,000 - $200,000)]. There would also be a $40,000 ($150,000 - $110,000) terminal loss on the building. The inclusion in Net Income For Tax Purposes would be $10,000 ($50,000 - $40,000).

8-67. If, for example, $30,000 of the proceeds were shifted from the building to the land, the result would be a $15,000 increase in the taxable capital gain, accompanied by a $30,000

increase in the terminal loss on the building. Clearly, there is an incentive to maximize the amount of the proceeds of disposition that is allocated to the land.

### The Solution

8-68. Because of this incentive, ITA 13(21.1)(a) contains a provision that can serve to limit the amount of any terminal loss that might arise on the disposition of real property. Using the example from Paragraph 8-65, this provision requires a deemed proceeds of disposition for the building to be determined as the lesser of the following two values:

| | | |
|---|---|---|
| • The FMV of the land and building | $410,000 | |
| Reduced By The Lesser Of: | | |
| • The ACB of the land = $200,000 | | |
| • The FMV of the land = $300,000 | ( 200,000) | $210,000 |
| • The Greater Of: | | |
| • The FMV of the building = $110,000 | | |
| • The Lesser Of: | | |
| The cost of the building = $175,000 | | |
| The UCC of the building = $150,000 | | $150,000 |

8-69. In this case, the proceeds that would be allocated to the building would be $150,000, leaving $260,000 ($410,000 - $150,000) to be allocated to the land. The net result is that the $40,000 terminal loss is completely eliminated and the capital gain is reduced by a corresponding amount to $60,000 ($260,000 - $200,000). The taxable amount of $30,000 [($60,000)(1/2)] would be included in the taxpayer's income instead of the $10,000 that would have been recorded in the absence of the special rule in ITA 13(21.1).

8-70. The effect of ITA 13(21.1)(a) on the results is summarized in the following table:

| | Results Without ITA 13(21.1)(a) | Results With ITA 13(21.1)(a) |
|---|---|---|
| Taxable Capital Gain | $50,000 | $30,000 |
| Terminal Loss | ( 40,000) | Nil |
| Net Inclusion | $10,000 | $30,000 |

8-71. If the potential capital gain had been less than the potential terminal loss, the terminal loss would have been reduced by the amount of the potential capital gain and the capital gain would have been eliminated. You might also note that this special rule only affects the vendor and has no tax consequences for the purchaser.

## Exercise Eight - 7

**Subject:** Building Dispositions

On February 24, 2019, Drucker Ltd. disposed of real property for total proceeds of $1,250,000. Information with respect to this property is as follows:

| | |
|---|---|
| Original cost of building | $930,000 |
| UCC Class 1 (Building - only asset in class) | 615,000 |
| Fair market value of building on February 24, 2019 | 500,000 |
| Adjusted cost base of land | 425,000 |
| Fair market value of land on February 24, 2019 | 750,000 |

Determine the tax consequences of this disposition assuming (1) there is no special rule for building dispositions, and (2) the ITA 13(21.1) special rule for building dispositions applies.

**SOLUTION available in print and online Study Guide.**

# Provisions For Special Assets

## Principal Residence

### Principal Residence Defined

8-72. For many individuals resident in Canada, one of the most attractive features of our tax system is the fact that, in general, capital gains arising on the disposition of a principal residence can be received free of tax. It is important to note that only one taxpayer in a family unit can designate a property as a principal residence for a particular year. For this purpose, a family unit includes a spouse or common-law partner, as well as children unless they are married or in a common-law partnership, or over 18 during the year.

8-73. ITA 54 defines a principal residence as any accommodation owned by the taxpayer that was ordinarily inhabited in the year by the taxpayer, his spouse, a former spouse, or a child, and is designated by the taxpayer as a principal residence. The definition notes that this would include land up to a limit of one-half hectare as well as a building. If the property includes additional land, it will be subject to capital gains taxation unless the taxpayer can demonstrate that the additional land was necessary for the use and enjoyment of the property.

8-74. An individual taxpayer may own more than one property that would meet the definition of a principal residence. A typical example of this would be a family that has both a city home and cottage in the country. Either of these properties could satisfy the definition of a principal residence and, given that a family can have only one property that qualifies for the principal residence exemption, a sale of either property would require a decision as to whether that property should benefit from the exemption. This choice can be clarified by the use of form T2091, *Designation Of A Property As A Principal Residence By An Individual*.

8-75. Prior to 2016, it was the administrative policy of the CRA not to require reporting of the sale of a principal residence or the filing of form T2091. However, as of January 1, 2016, the reporting related to the sale of a principal residence has been expanded.

8-76. Relevant points with respect to dispositions after 2015 are as follows:

- If an individual has only one property that qualifies as a principal residence, they must report in their tax return a description of the property sold, when it was acquired, and the proceeds of disposition. Form T2091 is not required.
- The same reporting is required if the individual owns more than one property that qualifies as a principal residence, but is designating only one property sold for all years owned.
- If the individual owns more than one property that qualifies as a principal residence, for reasons that will be discussed later, that individual may want to allocate some ownership years to each of the two properties. In this type of situation, form T2091 is required. This would be in addition to reporting any resulting capital gain in the usual schedule (S3) in their tax return.

8-77. Failure to report the disposition will result in a penalty of \$100 per month, to a maximum value of \$8,000.

### Gain Reduction Formula

8-78. Technically speaking, capital gains on a principal residence are taxable. However, ITA 40(2)(b) provides a formula for reducing such gains. The formula calculates the taxable portion, which is based on the relationship between the number of years since 1971 that the property has been designated a principal residence and the number of years since 1971 that the taxpayer has owned the property. It is as follows:

$$\mathbf{A} - \left[\mathbf{A} \times \frac{\mathbf{B}}{\mathbf{C}}\right] - \mathbf{D}, \text{ where}$$

**A** is the total capital gain on the disposition of the principal residence;
**B** is 1 plus the number of years since 1971 the property is designated as the taxpayer's principal residence (but cannot be greater than the denominator C);
**C** is the number of years since 1971 that the taxpayer has owned the property;
**D** relates to the 1994 capital gains election (not of general interest to users of this text).

8-79. The formula in Paragraph 8-78 is applied to any capital gain resulting from the disposition of a principal residence in order to determine the amount that will be subject to taxation. For example, assume a property was purchased in 2011 and was sold in 2019 for an amount that resulted in a capital gain of $100,000. If it was designated as a principal residence for 6 of the 9 years of ownership (not 8 years, a common error being to simply subtract the years without adding 1 for the initial year), the calculation of the taxable portion of the capital gain would be as follows:

$$\left[\$100{,}000 - (\$100{,}000)\left(\frac{1+6}{9}\right)\right]\left[\frac{1}{2}\right] = \$11{,}111$$

8-80. If a taxpayer has only a single property that could qualify as a principal residence, that property can be designated as the principal residence for all years owned. In such situations, the use of this formula will then completely eliminate any capital gains on the disposition of that property.

8-81. When only one residence is involved in each year, the plus one in the B component of the formula is not relevant. However, if a taxpayer sells one home and acquires another in a single year, the plus one becomes important.

**EXAMPLE** During 2014, Mr. Fodor acquires a principal residence at a cost of $130,000. The residence is sold in 2017 for $150,000. A replacement residence is acquired in 2017 at a cost of $170,000. In 2019, the second residence is sold for $200,000, with Mr. Fodor moving to an apartment.

**ANALYSIS** During 2017, Mr. Fodor owns two properties, only one of which can be designated as a principal residence for that year. If there was no extra year in the numerator of the reduction formula (component B), Mr. Fodor would be taxed on a portion of one of the gains. For example, assume Mr. Fodor allocates the 3 years 2014 through 2016 to the first property and the 3 years 2017 through 2019 to the second. All of the $30,000 gain on the second property would be eliminated. Since the first property was sold in 2017, the denominator in the reduction formula (component C) is 4 (2014 to 2017). If the plus one was not in the numerator, only three-quarters of the $20,000 gain would be eliminated, leaving a capital gain of $5,000 [$20,000 - ($20,000)(3 ÷ 4)]. However, with the addition of the plus one to the years in the numerator of the reduction formula, the fraction on the first property becomes four-fourths, and there is no taxable capital gain.

## Exercise Eight - 8

**Subject:** Sale Of Principal Residence

Mr. Norm Craft purchases his first home in 2010 at a cost of $89,000. In 2015, this home is sold for $109,500 and a second home is purchased for $152,000. In 2019, this second home is sold for $178,000 and Mr. Craft moves to a rental property. Determine the minimum tax consequences of the two property sales.

**SOLUTION available in print and online Study Guide.**

## Exercise Eight - 9

**Subject:** Sale Of Principal Residence

Ms. Jan Sadat owns a house in Ottawa, as well as a cottage in Westport. She purchased the house in 2008 for $126,000. The cottage was gifted to her in 2011 by her parents. At the time of the gift, the fair market value of the cottage was $85,000. During June, 2019, both properties are sold, the house for $198,000 and the cottage for $143,500. She has lived in the Ottawa house during the year, but has spent her summers in the Westport cottage. Determine the minimum capital gain that she must report on the 2019 sale of the two properties.

**SOLUTIONS available in print and online Study Guide.**

**We suggest you work Self Study Problem Eight-7 at this point.**

### *Non-Residential Usage Of Principal Residence*

8-82. A complication arises when a taxpayer either begins to rent a part of his principal residence, or begins to use it for non-residential purposes (e.g., a self-employed individual who maintains an office at home). Under the general rules for capital assets, this would be a partial change in use (coverage of change in use begins at Paragraph 8-113), potentially resulting in a capital gain on a partial disposition of the property.

8-83. However, the CRA has indicated in IT Folio S1-F3-C2, *Principal Residence* and IT Folio S4-F2-C2, *Business Use of Home Expenses* that it will not apply the partial disposition rules so long as the income producing use is ancillary to the main use as a principal residence, there is no structural change to the property, and no capital cost allowance is claimed. Given this, the standard tax planning advice to taxpayers who use a portion of their principal residence for business purposes is not to deduct CCA on this property.

### *Principal Residence On Farm Properties*

8-84. Many farmers have a principal residence that is a part of their farm property. This means that when the farm is sold, the farmer's principal residence will generally be included in the package that is sold. In this situation, ITA 40(2)(c) identifies two approaches that can be used in this situation.

8-85. The first approach requires that the land be divided into two components — the portion used for farming and the portion used for the use and enjoyment of the principal residence. Separate capital gains are calculated for each, with the gain on the principal residence portion being eligible for the principal residence reduction. Note that the ITA 54 definition of principal residence indicates that, as a general guideline, the land required for the use and enjoyment of the principal residence is limited to one-half hectare (i.e., 1.25 acres).

8-86. As an alternative, a farmer can elect to be taxed on the capital gain from the sale of the entire property, reduced by a fixed amount of $1,000, plus an additional $1,000 per year for every year for which the property was a principal residence.

## Personal Use Property

### *Definition*

8-87. ITA 54 defines personal use property as any property that is owned by the taxpayer and used primarily for his personal use or enjoyment, or for the personal use or enjoyment of one or more individuals related to the taxpayer. In non-technical terms, we are talking about any significant asset owned by a taxpayer that is not used for earning business or property income. This would include personal use automobiles, principal residences, vacation homes, boats, furniture, and many other items.

### Capital Gains And Losses

8-88. In general, gains on the disposition of personal use property are taxed in the same manner as gains on other capital assets. However, there is an important difference with respect to losses. In general, losses on such property are not deductible. The reason for this is that most types of personal use property depreciate over time and to allow capital losses on the property to be deductible would, in effect, permit a write-off of the cost of personal living expenses. As explained later, beginning in Paragraph 8-92, the exception to this general rule is losses on listed personal property that can be deducted on a restricted basis.

8-89. To simplify the enforcement of capital gains taxation on personal use property, ITA 46(1) provides a $1,000 floor rule. In using this rule to calculate capital gains on personal use property, the proceeds are deemed to be the greater of $1,000 and the actual proceeds. In a similar fashion, the adjusted cost base is deemed to be the greater of $1,000 and the actual adjusted cost base. This rule is illustrated in the following example involving dispositions of personal use property in four different cases:

**Capital Gains (Losses) On Personal Use Property**

| | Case A | Case B | Case C | Case D |
|---|---|---|---|---|
| Proceeds Of Disposition (POD) | $300 | $850 | $ 500 | $1,500 |
| Adjusted Cost Base (ACB) | 800 | 400 | 1,300 | 900 |
| Using the $1,000 floor rule results in the following capital gain or loss: | | | | |
| Greater Of Actual POD Or $1,000 | $1,000 | $1,000 | $1,000 | $1,500 |
| Greater Of ACB Or $1,000 | ( 1,000) | ( 1,000) | ( 1,300) | ( 1,000) |
| Gain (Non-Deductible Loss) | Nil | Nil | ($ 300) | $ 500 |

8-90. In situations where a taxpayer disposes of a part of an item of personal use property while retaining the remainder, the taxpayer must establish the ratio of the adjusted cost base of the part disposed of, to the total adjusted cost base of the property. Then, in applying the $1,000 floor rule, the adjusted cost base is deemed to be the greater of the portion of the adjusted cost base associated with the part disposed of, or the same portion of $1,000. In the same fashion, the proceeds would be deemed to be the greater of the actual proceeds and the appropriate portion of $1,000.

8-91. The government perceived an abuse of this $1,000 floor rule in art donation schemes where individuals would acquire art in bulk for nominal amounts ($10 each) and would then donate them immediately to various educational institutions at values apparently determined by questionable appraisers ($1,000 or less). The capital gains would be exempt because of the $1,000 floor rule, but the individuals would receive charitable donation receipts of $1,000. As a result, ITA 46(5) excludes certain property from the $1,000 rule when it is donated as part of a scheme to receive donation receipts of artificially high value.

## Listed Personal Property

8-92. Listed personal property consists of certain specified items of personal use property. The specified items are found in ITA 54 as follows:

(i) print, etching, drawing, painting, sculpture, or other similar work of art,
(ii) jewelry,
(iii) rare folio, rare manuscript, or rare book,
(iv) stamp, or
(v) coin.

8-93. In general, listed personal property is subject to the same capital gains rules as would apply to other personal use property. This would include the applicability of the $1,000 floor rule. However, there is one very important difference. While, in general, losses on personal use property cannot be deducted, allowable capital losses on listed personal property can be

deducted subject to a significant restriction.

8-94. The restriction is that allowable capital losses on listed personal property can only be deducted against taxable capital gains on listed personal property. In the absence of such taxable capital gains, the listed personal property losses cannot be deducted. However, any undeducted losses are subject to the carry over provisions described in Chapter 11.

### Exercise Eight - 10

**Subject:** Personal Use Property

During the current year, Martha Steward disposes of several items. The proceeds of disposition and the adjusted cost base of the various items are as follows:

| | Adjusted Cost Base | Proceeds Of Disposition |
|---|---|---|
| Sailboat | $43,000 | $68,000 |
| Oil Painting | 200 | 25,000 |
| Personal Automobile | 33,000 | 15,000 |
| Diamond Necklace | 46,000 | 18,000 |

What is the net tax consequence of these dispositions?

**SOLUTION available in print and online Study Guide.**

**We suggest you work Self Study Problem Eight-8 at this point.**

## Gains And Losses On Foreign Currency

### *Introduction*

8-95. As foreign currency exchange rates are constantly fluctuating, any taxpayer who engages in foreign currency transactions is certain to experience gains and losses that relate to these fluctuations. With respect to dealing with the tax aspects of foreign currency transactions, there are two basic issues:

**Income Vs. Capital Transactions** If a foreign exchange gain or loss arises as the result of an income transaction (i.e., buying or selling goods or services with the amounts denominated in foreign currency), the full amount will be taxable or deductible. In contrast, if a foreign exchange gain or loss arises as the result of a capital transaction (i.e., purchase of, sale of, or financing of, a capital asset), only one-half of the amount will be taxable or deductible.

**Regular Vs. Foreign Currency Capital Gains** The issue here is whether the gain on a particular capital transaction is a regular capital gain as defined in ITA 39(1) or, alternatively, a "capital gain or loss in respect of foreign currencies" as described in ITA 39(1.1). For individuals, under ITA 39(1.1) the first $200 of a foreign currency gain for the year is not subject to tax and the first $200 of a foreign currency loss cannot be claimed. This reduces the need to account for and report small foreign currency gains and losses, i.e., vacationers returning to Canada converting their remaining foreign currency to Canadian dollars.

### *Foreign Currency Income Transactions*

8-96. Foreign currency income transactions usually result in exchange gains and losses. For example, if a Canadian business acquires goods in the U.S. for US$5,000 at a point in time when US$1.00 = C$1.25, no gain or loss would arise if the goods were paid for immediately. However, if the goods are paid for at a later point in time when US$1.00 = C$1.27, there would be an exchange loss of C$100 [(US$5,000)(C$1.25 - C$1.27)]. The issue here is

whether the loss should be recognized only when the payable is settled or, alternatively, accrued if a Balance Sheet date occurs before the payment.

8-97. IT-95R indicates that, with respect to income transactions, the taxpayer can use any method that is in accordance with generally accepted accounting principles (GAAP). Under GAAP, current payables and receivables must be recorded at current rates of exchange as at each Balance Sheet date. Any gain or loss arising on the conversion must be taken into income at the time of conversion. Such gains and losses cannot be deferred until settlement. No alternative method is acceptable.

8-98. The resulting changes in value must be recorded as gains or losses at the time they are measured. As this is the only acceptable method under GAAP, it would require that foreign exchange gains and losses on income transactions be taken into income on an accrual basis, rather than waiting until the foreign exchange balance is settled in Canadian dollars.

### Capital Transactions Involving Foreign Currency Financing

8-99. Purchases or sales of capital assets may be financed with long-term payables or receivables that are denominated in a foreign currency. In such situations, the foreign exchange gains and losses on the payables or receivables are considered to be capital gains or losses.

8-100. The accounting rules here are consistent with those applicable to income transactions. That is, changes in the value of payables and receivables, along with the resulting gains or losses, are recognized and taken into income as of each Balance Sheet date.

8-101. It is somewhat surprising that the CRA does not permit this approach. While it does not address the issue of gains and losses on long-term receivables, Paragraph 13 of IT-95R states that:

> The Department considers that a taxpayer has "made a gain" or "sustained a loss" in a foreign currency ... resulting in the application of subsection 39(2) ...
>
> (c) at the time of repayment of part or all of a capital debt obligation.

8-102. This means that, if a Canadian company has used long-term foreign currency debt to finance capital assets, no exchange gain or loss will be included in the determination of Net Income For Tax Purposes until the debt matures and is paid off in Canadian dollars. This may result in significant differences between accounting Net Income and Net Income For Tax Purposes.

### Foreign Currency Purchase And Sale Of Securities

8-103. Individuals will most commonly encounter foreign exchange gains or losses when they are involved in purchasing or selling securities with settlement amounts denominated in a foreign currency. For purposes of distinguishing between ordinary capital gains and those that can be classified under ITA 39(2) as being in respect of foreign currencies, IT-95R provides the following examples of the time when the Department considers a transaction resulting in the application of ITA 39(2) to have taken place:

(a) At the time of conversion of funds in a foreign currency into another foreign currency or into Canadian dollars.

(b) At the time funds in a foreign currency are used to make a purchase or a payment (in such a case the gain or loss would be the difference between the value of the foreign currency expressed in Canadian dollars when it arose and its value expressed in Canadian dollars when the purchase or payment was made).

8-104. An example will serve to illustrate this approach:

> **EXAMPLE** On August 1, 2016, Mr. Conrad White uses $180,000 to open a British pound (£) account with his broker. Assume that at this time, £1 = $1.80, so that his $180,000 is converted to £100,000.

On December 31, 2016, he uses his entire British pound balance to acquire 10,000 shares in a British company, Underling Ltd. at a cost of £10 per share. At this time, £1 = $1.82. On July 1, 2019, the shares are sold for £21 per share. On this date, £1 = $1.65, and all of the proceeds from the sale are immediately converted into $346,500 [(10,000)(£21)($1.65)] Canadian dollars.

**ANALYSIS - Purchase** As a result of his December 31, 2016 purchase, he will have an exchange gain of $2,000 [(£100,000)($1.82 - $1.80)]. As this qualifies as an ITA 39(2) foreign currency capital gain (see Paragraph 8-103), Mr. White will only include $900 [(1/2)($2,000 - $200)] of this in his Net Income For Tax Purposes.

**ANALYSIS - Sale** When he sells the shares for £21 per share, his total capital gain is $164,500 [(£210,000)($1.65) - (£100,000)($1.82)]. This entire amount would be treated as an ITA 39(1) (regular) capital gain and would not be eligible for the $200 exclusion that is available to individuals. This result is not influenced by the conversion of the British currency into Canadian dollars. However, if the £210,000 proceeds were not converted and, at a later point in time, were converted into Canadian dollars at a rate other than £1 = $1.65, an ITA 39(2) foreign currency capital gain or loss would arise.

8-105. Without going into detail, these procedures are not consistent with GAAP or reasonable economic analysis. Under GAAP, no gain would be recognized at the time of the share purchase. Because of this, there would be a gain at the time of sale of $166,500 [(£210,000)($1.65) - (£100,000)($1.80)].

### *Funds On Deposit*

8-106. IT-95R also notes that foreign currency funds on deposit are not considered to be disposed of until they are converted into another currency, or are used to purchase a negotiable instrument or some other asset. This means that foreign funds on deposit may be moved from one form of deposit to another and, as long as such funds can continue to be viewed as "on deposit", no gain or loss will be recognized.

### Exercise Eight - 11

**Subject:** Foreign Currency Gains And Losses

On January 5, 2018, Mr. Michel Pratt purchases 35,000 Trinidad/Tobago dollars (TT$) at a rate of TT$1 = C$0.21. Using TT$30,600 of these funds, on June 5, 2018, he acquires 450 shares of a Trinidadian company, Matim Inc., at a price of TT$68 per share. At this time, TT$1 = C$0.23. During September, 2019, the shares are sold for TT$96 per share. The Trinidad/Tobago dollars are immediately converted into Canadian dollars at a rate of TT$1 = C$0.19. What amounts will be included in Mr. Pratt's 2018 and 2019 Net Income For Tax Purposes as a result of these transactions?

**SOLUTION available in print and online Study Guide.**

**We suggest you work Self Study Problem Eight-9 at this point.**

## Options

8-107. The term "option" would include stock rights, warrants, options to purchase capital assets, as well as stock options granted to executives and other employees (the special rules related to options granted to employees were covered in Chapter 3). From the point of view of the taxpayer acquiring these options, they are treated as capital property. The tax consequences related to such options will vary depending on future events:

- If they are sold before their expiry date, a capital gain or loss will usually arise.
- If they are exercised, the cost of acquiring the options will be added to the adjusted cost base of the assets acquired.
- If the options expire before they are either sold or exercised, a capital loss equal to the cost of the options will be incurred.

8-108. From the point of view of the issuer of the option, any proceeds from the sale of the option will usually be treated as a capital gain at the time the option is issued. If the holder decides to exercise the option, the sale price of the option becomes part of the proceeds of disposition to the issuer and the original gain on the sale of the option is eliminated. If the sale of the option occurs in a different taxation year than the exercise of the option, the issuer is permitted to file an amended return for the year of sale.

8-109. An example will serve to illustrate the preceding rules.

**EXAMPLE** John Powers has a capital property with an adjusted cost base of $250,000. During 2019, he sells an option on this property to Sarah Myers for $18,000. This option allows her to acquire the capital property for $300,000 at any time prior to December 31, 2022.

**ANALYSIS - Option Expires** Mr. Powers, as a result of selling the option in 2019, will have to record a taxable capital gain of $9,000 [(1/2)($18,000)] in that year. If the option expires, there will be no further tax consequences to Mr. Powers as he has already recognized the $9,000 taxable capital gain in 2019. For Ms. Myers, the expiry of the option will allow her to recognize an allowable capital loss of $9,000.

**ANALYSIS - Option Is Exercised** If the option is exercised in 2022, Mr. Powers can file an amended return for 2019, removing the capital gain that was recognized in that year. However, if he does, he will have to include the $18,000 in the proceeds of disposition from the sale of the asset, thereby recording a capital gain of $68,000 ($18,000 + $300,000 - $250,000). Ms. Myers will have acquired the capital property at a cost of $318,000 ($300,000 + $18,000).

8-110. There are three exceptions to the preceding general rules for vendors of options. The first of these is an exemption from taxation on the proceeds of any options sold on a taxpayer's principal residence.

8-111. The second involves options sold by a corporation on its capital stock or debt securities. In this situation, the corporation will not be taxed on the proceeds at the time the options are sold. Rather, the proceeds will be treated as part of the consideration for the securities issued if the options are exercised. However, if the options expire without being exercised, the corporation will have a capital gain equal to the amount of the proceeds.

8-112. The third exception relates to options granted by a trust to acquire units of the trust that are to be issued by the trust.

# Deemed Dispositions - Change In Use

## General Rules

### *Deemed Disposition*

8-113. The Glossary to this text (see the Study Guide) defines deeming rules and deemed disposition as follows:

**Deeming Rules** Rules that are used to require that an item or event be given a treatment for tax purposes that is not consistent with the actual nature of the item or event.

**Deemed Disposition** A requirement to assume that a disposition has taken place when, in fact, a disposition transaction has not occurred.

8-114. Such rules are fairly common in the *Income Tax Act* and are applied in a wide variety of situations. In this Chapter 8, we will deal with the deemed dispositions that occur when there is a change in use, and the deemed dispositions that occur when a taxpayer departs from

Canada. In Chapter 9, we will provide coverage of the deemed dispositions that occur when an individual dies.

8-115. You should also note that, since no real proceeds of disposition are involved in deemed dispositions, we will also need a deemed proceeds of disposition. The most common situation here is that the proceeds of disposition will be based on fair market values.

### Change In Use

8-116. The basic idea here is that when a property used to produce income is converted to some other purpose or, alternatively, when a property that was acquired for some other purpose becomes an income producing property, ITA 13(7) requires that the change be treated as a deemed disposition combined with a simultaneous deemed reacquisition.

8-117. Different rules apply, depending on whether the change is from business to personal use or, alternatively, from personal to business use. We will give separate attention to each of these changes. In addition, we will cover some special change in use rules that apply to principal residences and to automobiles that are owned by an individual.

## Business To Personal Use

8-118. This situation is straightforward. If the conversion is from business to personal use, the deemed proceeds will be equal to fair market value, with the transferor recognizing a capital gain, recapture, or terminal loss in the usual manner. The fair market value will also be used as the acquisition cost of the personal use asset.

## Personal To Business Use

8-119. If a personal use asset is converted to an income producing asset, the rules vary depending on the relationship between the fair market value of the asset and its cost.

> **Fair Market Value Less Than Cost** In this case, the fair market value will serve as both the proceeds of the deemed disposition and as the capital cost of the asset reacquired.
>
> **Fair Market Value Greater Than Cost** In this case, the fair market value will serve as the proceeds of the deemed disposition, resulting in the recognition of a capital gain. However, under ITA 13(7)(b), the capital cost of the reacquired asset for CCA purposes will be equal to its cost, plus one-half of the difference between its cost and its fair market value. While this value will be used for determining CCA and recapture amounts, for purposes of determining the capital gain on the deemed disposition, the capital cost will be deemed to be the full fair market value of the asset.

8-120. There is a reason for this different rule in situations where the fair market value exceeds the cost. It reflects the fact that only one-half of the capital gain that arises on such a deemed disposition will be subject to tax. If the reacquisition was recorded at the full fair market value of the asset, 100 percent of the capital gain amount could be deducted as CCA. A simple example will serve to illustrate this problem.

> **EXAMPLE** Shirley Malone owns a pleasure boat, which cost $100,000. She is changing its use to a charter boat and, at the time of the change, the fair market value of the boat is $150,000.
>
> **ANALYSIS** Shirley's deemed proceeds of disposition will be $150,000, resulting in a capital gain of $50,000. This will increase her Net Income For Tax Purposes by one-half of this amount or $25,000.
>
> The deemed Capital Cost of the boat to the charter operation, for capital gains purposes, will also be $150,000. This value will be used in the determination of any capital gain that might arise on a future disposition of the sailboat. As it is a depreciable asset, there could be no capital loss.

If the $150,000 was also used as the basis for CCA, Shirley would be able to deduct 100 percent of the $50,000 increase in value that occurred while she owned the boat for personal use. This would not be an equitable result as Shirley only paid taxes on $25,000 of this increase.

Given this, in situations where there is a gain on the change in use, the capital cost addition for CCA purposes will be limited to the cost of the asset, plus one-half of the gain (the taxable portion of the capital gain, a.k.a. the bump up). This means that for the purpose of determining CCA or recapture, Shirley's UCC balance will be $125,000 [$100,000 + (1/2)($150,000 - $100,000)].

## Example - Change In Use

8-121. The following example will serve to illustrate the procedures associated with changes in use.

**EXAMPLE** On January 1, 2019, Ms. Barker, a professional accountant, acquires a building at a cost of $500,000, with $400,000 allocated to the building and $100,000 allocated to the land. During the entire year, 20 percent of the floor space was used for her accounting practice, while the remainder was used as her principal residence.

On January 1, 2020, an additional 30 percent of the total floor space was converted to business use. On this date, the fair market value of the real property had increased to $620,000, with $480,000 allocated to the building and $140,000 allocated to the land.

On January 1, 2021, the entire building was converted to residential use as Ms. Barker's accounting practice had grown to the point where it had to move to more extensive facilities. On this date, the fair market value had increased to $700,000, with $550,000 allocated to the building and $150,000 allocated to the land.

**ANALYSIS** In using this example, we will focus only on the determination of CCA and any tax consequences associated with the changes in use. We will assume that net rental revenues are adequate to claim maximum CCA.

**2019 CCA Calculation** The maximum 2019 CCA would be calculated as follows:

| | |
|---|---|
| January 1, 2019 UCC | Nil |
| Add: Cost Of Acquiring Business Portion [(20%)($500,000 - $100,000)] | $80,000 |
| Deduct: One-Half Net Additions [(1/2)($80,000)] (Note) | ( 40,000) |
| Base Amount For CCA Claim | $40,000 |
| Deduct: CCA For The Year [(4%)($40,000)] | ( 1,600) |
| Add: One-Half Net Additions (Note) | 40,000 |
| January 1, 2020 UCC (For 20 Percent Of The Building) | $78,400 |

**NOTE** We would note that property acquired in a deemed disposition resulting from a change in use does not qualify for the AccII provisions. ITR 1104(4) indicates that a property cannot qualify for these provisions if it has been used for any purpose prior to its acquisition.

With respect to the half-year rule, it does not apply to non-arm's length transactions, provided the property was a depreciable property prior to the change in its use (business to business changes). This is not such a transfer and the half-year rule applies.

**2020 Tax Consequences** The change in use would trigger capital gains on the land and building as follows:

| | Land | Building |
|---|---|---|
| Fair Market Value | $140,000 | $480,000 |
| Cost | ( 100,000) | ( 400,000) |
| Change In Value | $ 40,000 | $ 80,000 |
| Change In Use Percent | 30% | 30% |
| Capital Gain | $ 12,000 | $ 24,000 |
| Inclusion Rate | 1/2 | 1/2 |
| Taxable Capital Gain | $ 6,000 | $ 12,000 |

It is possible that this capital gain could be eliminated through the use of the principal residence exemption that was discussed earlier in this Chapter. However, if Ms. Barker claims CCA for 2019 on the business portion of the property, this exemption would be lost.

The calculation of the 2020 CCA deduction would be as follows:

| | | |
|---|---|---|
| January 1, 2020 UCC (For 20 Percent Of The Building) | | $ 78,400 |
| Add: Deemed Cost Of Increase In Business Usage: | | |
| Cost [(30%)($400,000)] | $120,000 | |
| Bump Up [(1/2)(30%)($480,000 - $400,000)] | 12,000 | 132,000 |
| Deduct: One-Half Net Additions [(1/2)($132,000)] | | ( 66,000) |
| CCA Base | | $144,400 |
| Deduct: CCA For The Year [(4%)($144,400)] | | ( 5,776) |
| Add: One-Half Net Additions | | 66,000 |
| January 1, 2021 UCC (For 50 Percent Of The Building) | | $204,624 |

**2021 Tax Consequences** As all of the building has been converted to personal use and is no longer being used for business purposes, there would be no CCA for 2021. However, there would be recapture of CCA as follows:

| | |
|---|---|
| January 1, 2021 UCC | $204,624 |
| Lesser Of: | |
| • Cost For CCA Purposes ($80,000 + $132,000) = $212,000 | |
| • Deemed Proceeds Of Disposition = [(20% + 30%)($550,000)] = $275,000 | ( 212,000) |
| Negative Ending UCC Balance = Recapture Of CCA | ($ 7,376) |

Note that the amount of this recapture of CCA is equal to the sum of the CCA ($1,600 + $5,776) that was taken in the two years during which some of the asset was used for business purposes.

The change in use would trigger capital gains on the land and building as follows:

| | Land | Building |
|---|---|---|
| Fair Market Value | $150,000 | $550,000 |
| Change In Use Percent | 50% | 50% |
| Deemed Proceeds Of Disposition | $ 75,000 | $275,000 |
| Cost Of 2019 Acquisition | | |
| 20 Percent Of $100,000 and $400,000 | ( 20,000) | ( 80,000) |
| Cost Of 2020 Acquisition | | |
| 30 Percent Of $140,000 and $480,000 | ( 42,000) | ( 144,000) |
| Capital Gain | $ 13,000 | $ 51,000 |
| Inclusion Rate | 1/2 | 1/2 |
| Taxable Capital Gain | $ 6,500 | $ 25,500 |

## Exercise Eight - 12

**Subject:** Change In Use - Personal Property To Rental Property

During July, 2019, Ms. Lynn Larson decides to use her summer cottage as a rental property. It has an original cost of $43,000 (building = $23,000, land = $20,000) and its current fair market value is $231,000 (building = $111,000, land = $120,000). It has never been designated as her principal residence.

Describe the 2019 tax consequences of this change in use, including the capital cost and UCC that will be applicable to the rental property. In addition, indicate the maximum amount of CCA that would be available for 2019.

**SOLUTION available in print and online Study Guide.**

## Special Rules For Principal Residences

### *Change In Use - Principal Residence To Rental Property*

8-122. As we have previously noted, when the use of a property is changed from personal to business, the *Income Tax Act* requires that this change be treated as a deemed disposition and reacquisition at fair market value. The conversion of a principal residence to a rental property is a common example of this type of situation and, in the absence of any election, the fair market value at the time of the change will become the capital cost of the rental property. As was previously discussed, if the fair market value exceeds the cost, a different value will be used for the calculation of CCA.

8-123. An alternative to this treatment is provided under ITA 45(2). Under this Subsection, the taxpayer can make an election under which he will be deemed not to have commenced using the property for producing income. Note that there is no required form for this election. It is made in the taxpayer's income tax return.

8-124. If this election is made, the taxpayer will still include the rents from the property as rental income and deduct all of the expenses associated with the property other than CCA. However, use of the ITA 45(2) election prevents the taxpayer from deducting any amounts for CCA on this property.

8-125. While this inability to deduct CCA can be viewed as a disadvantage associated with the election, the election does, in fact, have an offsetting advantage. Based on the ITA 54 definition of a principal residence, the property can continue to be designated as a principal residence for up to four years while the election is in effect. This would appear to be the case even in situations where the individual does not return to live in the property.

8-126. In practical terms, the preceding means that an individual who moves out of a principal residence can retain principal residence treatment for the property, for up to four years. This allows the individual to enjoy any capital gains that accrue on the property during that period on a tax free basis.

8-127. This would be of particular importance to an individual who moves to a rental property and does not have an alternative principal residence during this period. Even if the individual purchases an alternative residential property, the election can be helpful as it allows a choice as to which property will be designated as the principal residence during the relevant years. If one of the properties experiences a substantially larger capital gain during this period, the use of this election could produce a significant savings in taxes.

8-128. Also of interest is the fact that the four year election period can be extended. ITA 54.1 specifies that if the following conditions are met either by the taxpayer or the taxpayer's spouse or common-law partner, the election can be extended without limit:

- you leave the residence because your employer requires you to relocate;
- you return to the original residence while still with the same employer, or before the end of the year following the year you leave that employer, or you die before such employment terminates; and
- the original residence is at least 40 kilometers further from your new place of employment than your temporary residence.

## Exercise Eight - 13

**Subject:** Change In Use - Principal Residence To Rental Property

During 2014, Jan Wheatley acquired a new home at a cost of $220,000. On December 31, 2017, she moves from this home into an apartment. At this time, the home is appraised for $210,000. Because she believes that real estate in her area is temporarily undervalued, she decides to rent the property for a period of time and sell it at a later date. During 2018, she receives rents of $21,600 and has expenses, other than CCA, of $12,600. On January 1, 2019, she sells the home to the current tenant for $345,000.

Indicate the 2018 and 2019 tax consequences to Ms. Wheatley assuming that, in 2018, she does not elect under ITA 45(2) and deducts CCA. How would these results differ if she made the ITA 45(2) election? In providing your answers, ignore the cost of the land on which the home is located.

**SOLUTION available in print and online Study Guide.**

### *Change In Use - Rental Property To Principal Residence*

8-129. Here again, unless an election is made, this change in use will be treated as a deemed disposition at fair market value, with possible results including capital gains, recapture, or terminal loss. When this type of change occurs, ITA 45(3) allows an individual to elect out of the deemed disposition for capital gains purposes as long as no CCA has been taken on the property. To make the election, the taxpayer must notify the Minister in writing. The election must be made by the taxpayer's filing deadline for the year following the disposition (April 30 or June 15).

8-130. When the ITA 45(3) election is used, it is possible to designate the property as a principal residence for up to four years prior to the time it stopped being used as a rental property. This can be beneficial both to individuals who did not own another residential property during this four year period, and to individuals with an alternative residential property that experiences a capital gain at a lower annual rate, or a loss.

**BYRD/CHEN NOTE** The special change in use rules for principal residences that are available under ITA 45(2) and ITA 45(3) can be very valuable to taxpayers that have a change in use from either a principal residence to a rental property [ITA 45(2)], or from a rental property to a principal residence [ITA 45(3)]. These provisions allow either a deferral or an elimination of the unfortunate tax consequences that can occur as a result of the deemed disposition that is required by the general application of the change in use rules.

Under current legislation ITA 45(2) and 45(3) can only be used when there is a change in use that involves 100 percent of a particular residential property. They are not available when the change in use involves a portion of a multi-unit property. For example, if an individual converts one unit of a duplex from his principal residence to a rental property, ITA 45(2) cannot be used to defer the deemed disposition.

The March 19, 2019 Federal Budget contains proposals that would modify both ITA 45(2) and ITA 45(3) in a manner that would allow these provisions to be used when one unit of a multi-unit residential property is involved.

These proposals would be applicable to changes in use that occur after the budget day, March 19, 2019.

## Exercise Eight - 14

**Subject:** Change In Use - Rental Property To Principal Residence

On January 2, 2018, Lance Ho acquires a small condominium in downtown Toronto for $375,000. When his mother threatens to commit suicide if he ever moves out, he rents the unit to a friend until December 31, 2018. Net rental income, before any deduction for CCA, is $9,800. Mr. Ho's mother is hit by a bus and dies on December 26, 2018. The grieving Mr. Ho moves into the unit on January 1, 2019. At this time, the appraised value of the property is $450,000.

After moving in, he finds that the congested traffic in the downtown area is intolerable and, on December 31, 2019, he sells the unit for $510,000. Indicate the 2018 and 2019 tax consequences to Mr. Ho, assuming that he deducts CCA in 2018 and does not elect under ITA 45(3). How would these results differ had he not taken CCA and made the ITA 45(3) election? In providing your answers, ignore the cost of the land on which the condominium is located.

**SOLUTION available in print and online Study Guide.**

**We suggest you work Self Study Problems Eight-10 and Eight-11 at this point.**

## Special Rules For Automobiles

8-131. As was illustrated in the example in Paragraph 8-121, the change in use rules generally apply when there is a change in use involving only a part of an asset. If this rule was applied to automobiles used in employment or business activities, there would be a significant problem. As the deductible percentage of usage of usage would change each year, strict application of the rule would result in a deemed disposition/re-acquisition every year. However, as was discussed in Chapter 5, Capital Cost Allowance, an alternative approach is accepted by the CRA. As this alternative approach was illustrated in Chapter 5, it will not be presented again in this Chapter.

# Deemed Dispositions - Departures From Canada

### *Basic Rules*

8-132. When a taxpayer leaves Canada, ITA 128.1(4)(b) calls for a deemed disposition of all property owned at the time of departure. The disposition is deemed to occur at fair market value. If the taxpayer is an individual, certain types of property are exempted from this deemed disposition rule. The major categories of exempted property are as follows:

- Real property situated in Canada, Canadian resource properties, and timber resource properties.
- Property of a business carried on in Canada through a permanent establishment. This would include capital property and inventories.
- "Excluded Right or Interest" This concept is defined in ITA 128.1(10). The definition includes right and interests in Registered Pension Plans, Registered Retirement Savings Plans, Deferred Profit Sharing Plans, stock options, death benefits, retiring allowances, as well as other rights of individuals in trusts or other similar arrangements.

### Additional Complications

8-133. There are a number of other tax complications associated with both immigration and emigration. These include the ability to elect to have an exempt property taxed at the time of departure and procedures that allow a taxpayer to unwind a deemed disposition. These are given detailed attention in Chapter 20, International Issues In Taxation.

#### Exercise Eight - 15

**Subject:** Emigration

John Porker owns publicly traded securities with an adjusted cost base of $920,000 and a fair market value of $1,030,000. On April 21, 2019, he permanently departs from Canada still owning the shares. What would be the tax consequences of his departure, if any, with respect to these securities?

#### Exercise Eight - 16

**Subject:** Emigration

Ms. Shari Twain owns a rental property in London, Ontario with a capital cost of $275,000 and a fair market value of $422,000. The land values included in these figures are $75,000 and $122,000, respectively. The UCC of the building is $107,800. On December 31, 2019, Ms. Twain permanently departs from Canada still owning the property. What are the tax consequences of her departure, if any, with respect to this rental property?

**SOLUTIONS available in print and online Study Guide.**

**We suggest you work Self Study Problem Eight-12 at this point.**

# Deferral Provisions On Small Business Investments

## Basic Provision

8-134. ITA 44.1 was introduced to provide small businesses, especially start-up companies, with greater access to risk capital. It provides for the deferral of capital gains resulting from the disposition of "eligible small business corporation shares" when sold by an individual. The deferral is conditional on reinvestment of some or all of the proceeds of disposition in other eligible small business corporation shares (replacement shares). As you would expect, the adjusted cost base of these replacement shares will be reduced by the capital gain that is eliminated in the current year. In effect, this defers the gain until such time as the new investment is sold and not reinvested in replacement shares.

## Definitions

8-135. ITA 44.1 is a very technical Section of the *Act* and, as such, requires a number of definitions. Some of the more important definitions are as follows:

**Eligible Small Business Corporation** To be eligible for the deferral, the corporations must comply with the definition of an eligible small business corporation. This is a Canadian controlled private corporation that has substantially all (meaning more than 90 percent) of the fair market value of its assets devoted principally to an active business carried on primarily (meaning more than 50 percent) in Canada. The corporation's qualifying assets include its holdings of shares or debt in other eligible small business corporations. To be eligible for the ITA 44.1 provisions, the small business corporation and corporations related to it cannot have assets with a carrying value in excess of $50 million. Shares or debt of related corporations are not counted when determining the $50 million limit on assets.

**Qualifying Disposition** To qualify for the deferral, the gain must result from the sale of common shares in an eligible small business corporation that was owned by the investor throughout the 185 day period that preceded the disposition.

**Replacement Shares** These are common shares of an eligible small business corporation that are acquired within 120 days after the end of the year in which the qualifying disposition took place. They must be designated as replacement shares in the individual's tax return. Note that an individual can establish a deferral that is less than the maximum permitted amount by designating a lesser amount of replacement shares.

**Permitted Deferral** The deferral is limited to a fraction of the capital gain resulting from the qualifying disposition. The fraction is based on the ratio of the lesser of the cost of the replacement shares and proceeds of disposition, divided by the proceeds of disposition (the value cannot exceed one).

> **EXAMPLE** The common shares of an eligible small business corporation with an adjusted cost base of $2,000,000 are sold for $2,500,000. Within 30 days, $1,800,000 of the proceeds are used to purchase replacement shares.
>
> **ANALYSIS** The total gain is $500,000 ($2,500,000 - $2,000,000). Of this total, the maximum permitted deferral would be $360,000 [($500,000)($1,800,000 ÷ $2,500,000)].

**Adjusted Cost Base Reduction** The adjusted cost base of the replacement shares will have to be reduced by the amount of any capital gains deferral. Using the preceding example, the adjusted cost base of the replacement shares would be $1,440,000 ($1,800,000 - $360,000). If there is more than one block of replacement shares, this reduction will be allocated in proportion to their costs.

## Example

8-136. The following example illustrates the application of the ITA 44.1 deferral:

> **EXAMPLE** During the current year, an individual makes a qualifying disposition of shares of Corporation A with an adjusted cost base of $3,000,000, for proceeds of disposition of $4,500,000.
>
> Within 120 days after the current year end, the individual purchases replacement shares in Corporation B with a cost of $2,200,000 and in Corporation C with a cost of $2,300,000. Corporations A, B, and C are unrelated.
>
> **ANALYSIS** As the $4,500,000 proceeds of disposition is equal to the $4,500,000 ($2,200,000 + $2,300,000) cost of the replacement shares, the permitted deferral is equal to $1,500,000 [($1,500,000)($4,500,000 ÷ $4,500,000)], which is the total capital gain on the disposition.
>
> In calculating the adjusted cost base of the new shares, the $1,500,000 reduction would be allocated as follows:

| | B Shares | C Shares |
|---|---|---|
| Purchase Price | $2,200,000 | $2,300,000 |
| Deferral: | | |
| [($1,500,000)($2,200,000/$4,500,000)] | ( 733,333) | |
| [($1,500,000)($2,300,000/$4,500,000)] | | ( 766,667) |
| Adjusted Cost Base | $1,466,667 | $1,533,333 |

The total adjusted cost base is $3,000,000 ($1,466,667 + $1,533,333), which was the adjusted cost base of the Corporation A shares.

### Exercise Eight - 17

**Subject:** Deferral Of Small Business Gains

On January 15, 2019, Jerri Hamilton sells all of her common shares of Hamilton Ltd., an eligible small business corporation. She had owned the shares for 12 years. The adjusted cost base of these shares is $750,000 and they are sold for $1,350,000. On February 15, 2019, $1,200,000 of these proceeds are invested in the common shares of JH Inc., a new eligible small business corporation. How much of the capital gain arising on the sale of the Hamilton Ltd. shares can be deferred by the investment in JH Inc.? If the maximum deferral is elected, what will be the adjusted cost base of the JH Inc. shares?

**SOLUTION available in print and online Study Guide.**

**We suggest you work Self Study Problem Eight-13 at this point.**

# Deferral Provisions On Replacement Property

## The Problem

### *Potential Taxation*

8-137. The disposition of a capital property can give rise to capital gains and, in the case of depreciable capital property, recapture of CCA. In certain situations, such dispositions are unavoidable, with the related income inclusions creating significant financial problems for the taxpayer.

**EXAMPLE** An enterprise has its only Class 1 building completely destroyed by fire. The building has a capital cost of $1,200,000 and a UCC of $450,000. It is insured for its replacement cost of $4,000,000 and this amount is received during the current year.

**ANALYSIS** In the absence of any mitigating legislation, these events would result in a taxable capital gain of $1,400,000 [(1/2)($4,000,000 - $1,200,000)] and, if the building is not replaced during the current year, recapture of $750,000. The taxes on this $2,150,000 increase in Taxable Income would be added to the many other problems associated with the fire.

8-138. A similar problem may arise when a business changes its location. The sale of its old facilities may result in significant capital gains. In addition, if these old facilities are not replaced in the same year as their disposition, there may also be recapture of CCA.

### *Legislative Relief*

8-139. Given the problems such situations can generate, it is not surprising that the government has provided relief. The relevant provisions are ITA 13(4) which deals with the recapture problem and ITA 44(1), which deals with the capital gains.

8-140. In somewhat simplified terms, these provisions allow the taxpayer to eliminate or reduce capital gains and recapture that arise on qualifying dispositions. The use of these provisions is conditional on the replacement of the property within a specified period of time. There is a corresponding reduction in the capital cost and UCC of the replacement assets. This, in effect, defers these income inclusions until the replacement assets are sold or used.

8-141. You should note that the application of these provisions is not required. Both ITA 13(4) and ITA 44(1) are elections that are made in filing the taxpayer's return of income (i.e., there is no prescribed form). They do not apply automatically and, if the taxpayer fails to make the required elections, the result can be a significant increase in Tax Payable in the year of disposition.

## Voluntary And Involuntary Dispositions

8-142. There are two types of situations for which the combination of ITA 13(4) and ITA 44(1) provide relief. They can be described as follows:

> **Involuntary Dispositions** This description is used to describe dispositions of depreciable property resulting from theft, destruction, or expropriation under statutory authority. In the case of this type of disposition, the relieving provisions cover all types of depreciable property. These provisions are available as long as the replacement occurs within 24 months after the end of the year in which the proceeds of disposition were received.
>
> **Voluntary Dispositions** Voluntary dispositions most commonly involve the relocation of a business. As a relocation may involve a disposition, taxpayers undergoing a move may encounter problems similar to those experienced when there is an involuntary disposition. In these voluntary dispositions, the applicability of ITA 13(4) is more limited.
>
> Specifically, this provision only applies to "former business property", a term that is defined in ITA 248(1) to consist of real property or interests in real property. This means that assets other than those specified in the ITA 248 definition (e.g., equipment, furniture and fixtures) will not benefit from this provision. A further difference here is that the replacement must occur within 12 months after the year in which the proceeds of disposition are received.

## Timing Considerations

### *Dispositions*

8-143. Note that, from a technical point of view, a disposition does not take place until the proceeds become receivable. In the case of voluntary dispositions, the proceeds will become receivable at the time of sale. However, in the case of involuntary dispositions, the receipt of insurance or expropriation proceeds may occur in a taxation year subsequent to the theft, destruction, or expropriation of the property. For purposes of determining the 24 month replacement period, the clock will generally start ticking in this later year.

### *Replacements*

8-144. With respect to capital gains, they will be recognized in the year in which the disposition takes place. They will occur without regard to when the replacement is made. This means that their reduction or elimination will always require the application of ITA 44(1).

8-145. The situation with recapture is different. You will recall from Chapter 5 that recapture only occurs when there is a negative balance in the class at the end of the period. If the replacement occurs in the same period as the disposition, it is likely that there will be a positive balance in the class at the end of the period. If this is the situation, there is no recapture and the election under ITA 13(4) is not relevant.

8-146. A further point here is that, if the replacement occurs in a period subsequent to the disposition, the application of ITA 13(4) and ITA 44(1) will have to be implemented via an amended return for the period of disposition. Any capital gain or recapture that occurs at the time of disposition will, in effect, be reversed through the amended return.

## Application Of ITA 44(1) To Capital Gains

8-147. If a qualifying property is disposed of and replaced within the required time frame, ITA 44(1) provides an election that will reduce the capital gain to the lesser of:

- an amount calculated by the usual approach (proceeds of disposition, less adjusted cost base); and
- the excess, if any, of the proceeds of disposition of the old property over the cost of the replacement property. Provided the cost of the new property is equal to or exceeds the proceeds of disposition for the old property, this amount will be nil.

8-148. In somewhat simplified terms, if the cost of the replacement property is greater than the proceeds of disposition for the replaced property, no capital gain will be recorded if the appropriate election is made. We would remind you that, in those cases where the replacement occurs in a period subsequent to the disposition, this election will have to be applied as an adjustment to the return for the year of disposition.

**EXAMPLE** A taxpayer has land with an adjusted cost base of $600,000. It is expropriated by the local municipality. Compensation, which is paid immediately, is $1,000,000. It is replaced in the current taxation year with land, which costs $1,200,000.

**ANALYSIS** If no election is made under ITA 44(1), there will be a capital gain of $400,000 ($1,000,000 - $600,000) and the new land will have an adjusted cost base of $1,200,000.

Alternatively, if an election is made under ITA 44(1), the capital gain will be the lesser of:

- The capital gain as normally determined which is $400,000; and
- The excess, if any, of the proceeds of disposition of the old land ($1,000,000) over the cost of the replacement land ($1,200,000). Nil in this example.

Note that when ITA 44(1) is applied, any amount of capital gain that is deferred decreases the adjusted cost base of the replacement property. The adjusted cost base of the replacement land is decreased to $800,000 ($1,200,000 - $400,000).

8-149. If the replacement cost had been less than the expropriation proceeds, it would not have been possible to defer all of the capital gain. For example, if the cost of the replacement land had been $700,000, the minimum capital gain to be realized would be $300,000, the excess of the proceeds of disposition of $1,000,000 over the $700,000 replacement cost of the new property. This scenario would defer only $100,000 of the total $400,000 capital gain. The deferred capital gain of $100,000 would decrease the adjusted cost base of the replacement property to $600,000 ($700,000 - $100,000).

## Application Of ITA 13(4) To Recapture Of CCA

8-150. The application of ITA 13(4) is more complex. In order to focus on this application we will use an example in which the fair market value of the building is less than its capital cost, thereby avoiding the need to use ITA 44(1) to eliminate a capital gain.

**EXAMPLE** A company's only building is destroyed in a fire in February, 2018. The original cost of the building was $2,500,000, the fair market value is $2,225,000, and it is an older building with a UCC of only $275,000. The insurance proceeds, all of which are received in 2018 prior to the December 31 year end, equal the fair market value of $2,225,000. The replacement building is acquired in July, 2019 at a cost of $3,000,000.

**ANALYSIS** Deducting $2,225,000, the lesser of the proceeds of disposition and the capital cost of the building, from the UCC of $275,000 will leave a negative balance of $1,950,000. As there is no replacement of the asset during 2018, this negative balance will remain at the end of this year, resulting in recapture of CCA. This amount will have to be included in income for the 2018 taxation year and will be added back to the UCC, reducing the class balance to nil.

In 2019, the year in which the replacement occurs, the ITA 13(4) election provides for an alternative calculation of the 2018 recapture:

| | | |
|---|---|---|
| January 1, 2018 UCC Balance | | $275,000 |
| Deduction: | | |
| Lesser Of: | | |
| • Proceeds Of Disposition = $2,225,000 | | |
| • Capital Cost = $2,500,000 | $2,225,000 | |
| Reduced By The Lesser Of: | | |
| • Normal Recapture = $1,950,000 | | |
| • Replacement Cost = $3,000,000 | ( 1,950,000) | ( 275,000) |
| Recapture Of 2018 CCA (Amended) | | Nil |

8-151. IT-259R4 indicates that the election, including the relevant calculations, should be made in the form of a letter attached to the tax return in 2019, the year of replacement. In this example, the election would result in a $1,950,000 reduction in the company's 2018 Net Income For Tax Purposes and would likely provide the basis for a tax refund.

8-152. The $1,950,000 reduction of Net Income For Tax Purposes in the preceding calculation will have to be treated as deemed proceeds of disposition and subtracted from the UCC of the replacement asset. This will leave a balance of $1,050,000 ($3,000,000 - $1,950,000). This balance correctly reflects the economic substance of the events that have occurred:

| | | |
|---|---|---|
| Original UCC | | $ 275,000 |
| Additional Cash: | | |
| Excess Of The Replacement Cost | $3,000,000 | |
| Over The Proceeds Of Disposition | ( 2,225,000) | 775,000 |
| New UCC Balance | | $1,050,000 |

8-153. Note that the reversal of recapture is limited to the cost of the replacement property. In our example, if the cost of the replacement property had only been $1,800,000, this amount would have been the limit on the recapture reversal and the remaining $150,000 [$275,000 - ($2,225,000 - $1,800,000)] would have remained in 2018 income. In this case, the UCC of the replacement building would be nil ($1,800,000 - $1,800,000).

## Exercise Eight - 18

**Subject:** Involuntary Disposition - ITA 13(4) Election For Recapture

Foran Inc., a company with a December 31 year end, has the only building it owns destroyed by a meteorite during 2018. Its original cost was $1,500,000, its fair market value was $1,400,000, and the Class 1 UCC was $650,000. The Company receives $1,400,000 in insurance proceeds during 2018 and replaces the building with a used building at a cost of $2,350,000 in 2019. The Company makes the ITA 13(4) election to defer any recaptured CCA. What is the UCC of the replacement building?

**SOLUTION available in print and online Study Guide.**

## Combined Application Of ITA 13(4) And 44(1)

### *Example 1 - Replacement Cost Exceeds Proceeds Of Disposition*

8-154. Our first example of the combined application of ITA 13(4) and ITA 44(1) involves a situation where the replacement cost of the new asset exceeds the proceeds of disposition for the old asset.

> **EXAMPLE** During its 2018 taxation year, the Martin Company decides to change the location of its operations. Its current property consists of land with an adjusted cost base of $500,000, as well as a building with a capital cost of $1,500,000 and a UCC of $340,000. These assets are sold for a total price of $2,400,000, of which $600,000 is allocated to the land and $1,800,000 is allocated to the building. During January, 2019, a replacement property is acquired at a new location at a cost of $2,800,000, of which $700,000 is allocated to the land and $2,100,000 is allocated to the building.

> **ANALYSIS - Capital Gain** As a result of the disposition, the Martin Company will include the following amounts in its 2018 Net Income For Tax Purposes:

| | Old Land | Old Building |
|---|---|---|
| Proceeds Of Disposition | $600,000 | $1,800,000 |
| Adjusted Cost Base | ( 500,000) | ( 1,500,000) |
| Capital Gain | $100,000 | $ 300,000 |
| Inclusion Rate | 1/2 | 1/2 |
| Taxable Capital Gain | $ 50,000 | $ 150,000 |
| | | |
| Recapture Of CCA ($340,000 - $1,500,000) | N/A | $1,160,000 |

> When the replacement occurs in 2019, the cost allocated to the land and building exceeds the proceeds of disposition from these assets. As a consequence, the revised capital gain for 2019 will be nil, a fact that would be reflected in an amended 2019 tax return. However, the capital cost of the replacement assets would be reduced as follows:

| | New Land | New Building |
|---|---|---|
| Cost | $700,000 | $2,100,000 |
| Capital Gain Reversal - ITA 44(1) Election | ( 100,000) | ( 300,000) |
| Deemed Adjusted Cost Base/Capital Cost | $600,000 | $1,800,000 |

8-155. The economic basis for this result can be seen by noting that the combined deemed adjusted cost base of the new land and building is $2,400,000 ($600,000 + $1,800,000). This is equal to the combined adjusted cost base of the old land and building of $2,000,000 ($500,000 + $1,500,000), plus the additional $400,000 in cash ($2,800,000 - $2,400,000) required to finance the acquisition of the new land and building.

8-156. Using the ITA 13(4) formula, the amended 2018 recapture of CCA would be nil, calculated as follows:

| | | |
|---|---|---|
| UCC Balance | | $340,000 |
| Deduction: | | |
| Lesser Of: | | |
| • Proceeds Of Disposition = $1,800,000 | | |
| • Capital Cost = $1,500,000 | $1,500,000 | |
| Reduced By The Lesser Of: | | |
| • Normal Recapture = $1,160,000 | | |
| • Replacement Cost = $2,100,000 | ( 1,160,000) | ( 340,000) |
| Recapture Of 2018 CCA (Amended) | | Nil |

8-157. As would be expected when the replacement cost of the new building exceeds the normal recapture of CCA, the amended recapture of CCA will be nil. The reversal of the 2018 recapture of CCA will be reflected in the UCC of the new building as follows:

| | |
|---|---|
| Deemed Capital Cost Of Building | $1,800,000 |
| Recapture Reversal - ITA 13(4) Election | ( 1,160,000) |
| UCC | $ 640,000 |

8-158. As was the case with the capital cost of the new building, the economic basis for this result can also be explained. The new UCC of $640,000 is equal to the old UCC of $340,000, plus the $300,000 in cash ($2,100,000 - $1,800,000) required to finance the acquisition of the new building.

### *Example 2 - Proceeds Of Disposition Exceed Replacement Cost*

8-159. In the preceding example, we are able to remove 100 percent of the capital gain through the application of the ITA 44 election. This resulted from the fact that the cost of the replacement property exceeded the proceeds of disposition for the old property. If this is not the case, some of the capital gain will have to remain in income. This point can be illustrated by making a small change in our previous example by decreasing the replacement land cost by $150,000.

> **EXAMPLE** During its 2018 taxation year, the Martin Company decides to change the location of its operations. Its current property consists of land with an adjusted cost base of $500,000, as well as a building with a capital cost of $1,500,000 and a UCC of $340,000. These assets are sold for a total price of $2,400,000, of which $600,000 is allocated to the land and $1,800,000 is allocated to the building. During January, 2019, a replacement property is acquired at a new location at a cost of $2,650,000, of which $550,000 is allocated to the land and $2,100,000 is allocated to the building.

8-160. For the 2018 tax return, the capital gains and recapture on the disposition will be as presented in Paragraph 8-154. In 2019, when ITA 44(1) is applied, the minimum capital gain on the land that can be reversed would be the lesser of:

- $100,000 (the excess of the $600,000 proceeds of disposition over the $500,000 adjusted cost base); and
- $50,000 (the excess of the $600,000 proceeds of disposition over the $550,000 replacement cost).

8-161. The lesser amount is $50,000. When this amount of the capital gain is reversed, it leaves $50,000 ($100,000 - $50,000) in capital gains in 2018 income. With respect to the replacement values, the relevant tax values are as follows:

| | New Land | New Building |
|---|---|---|
| Cost | $550,000 | $2,100,000 |
| Capital Gain Reversal - ITA 44(1) Election | ( 50,000) | ( 300,000) |
| Deemed Adjusted Cost Base/Capital Cost | $500,000 | $1,800,000 |
| Recapture Reversal - ITA 13(4) Election | N/A | ( 1,160,000) |
| UCC | N/A | $ 640,000 |

### *Election To Reallocate Proceeds Of Disposition*

8-162. In the preceding example, the fact that the replacement cost of the land was less than the proceeds of disposition of the previously owned land, resulted in a situation where a portion of the capital gain on this disposition had to remain in the 2018 tax return. Fortunately, a further election contained in ITA 44 provides, in many cases, a solution to this problem.

8-163. Under ITA 44(6), the taxpayer is allowed to reallocate the total proceeds of disposition on the sale of a former business property, without regard to the respective market values of the land and building. If, in the example presented in Paragraph 8-159, the total proceeds of $2,400,000 are reallocated on the basis of $550,000 (originally $600,000 in Paragraph 8-154) to the land and $1,850,000 (originally $1,800,000) to the building, the 2018 taxable capital gains will be as follows:

| | Old Land | Old Building |
|---|---|---|
| Proceeds Of Disposition After Election | $550,000 | $1,850,000 |
| Adjusted Cost Base | ( 500,000) | ( 1,500,000) |
| Capital Gain | $ 50,000 | $ 350,000 |
| Inclusion Rate | 1/2 | 1/2 |
| Taxable Capital Gain | $ 25,000 | $ 175,000 |

8-164. While the total taxable capital gain remains the same, this reallocation of the total proceeds of disposition results in a situation where the replacement cost of both the land and building are equal to, or exceed, the proceeds of disposition. This, in turn, means that all of the capital gains on both of these capital assets will be removed from the 2018 amended tax return. Under this scenario, the tax values for the replacement assets would be as follows:

| | New Land | New Building |
|---|---|---|
| Cost | $550,000 | $2,100,000 |
| Capital Gain Reversal - ITA 44(1) Election | ( 50,000) | ( 350,000) |
| Deemed Adjusted Cost Base/Capital Cost | $500,000 | $1,750,000 |
| Recapture Reversal - ITA 13(4) Election | N/A | ( 1,160,000) |
| UCC | N/A | $ 590,000 |

8-165. Note that this election is not made without a cost. Had the $50,000 been left as a capital gain, tax would have applied on only one-half of the total. While we have eliminated this $25,000 in income, we have given up future CCA for the full amount of $50,000. In other words, we have given up $50,000 in future deductions in return for eliminating $25,000 of income in 2018. As explained in our Chapters 12 and 13 on corporate taxation, for some corporations, capital gains are initially taxed at higher rates than business income, which could be a factor in this decision. In addition, anticipated future tax rates could be a consideration.

## Exercise Eight - 19

**Subject:** Involuntary Dispositions - ITA 13(4) and 44(1) Elections

Hadfeld Ltd., a company with a December 31 year end, operates out of a single building that cost $725,000 in 2012. At the beginning of 2018, the UCC for its Class 1 was $623,150. On June 30, 2018, the building was completely destroyed in a fire. The building was insured for its fair market value of $950,000 and this amount was received in September, 2018. The building is replaced in 2019 at a cost of $980,000. Hadfeld Ltd. wishes to minimize income taxes. Describe the 2018 and 2019 tax consequences of these events, including the capital cost and UCC for the new building at the end of 2019. Ignore any gain or loss related to the land on which the building is located.

**SOLUTION available in print and online Study Guide.**

# Capital Gains And Tax Planning

8-166. The capital gains area offers many opportunities for effective tax planning since the realization of capital gains or losses is largely at the discretion of the taxpayer. If the taxpayer desires that gains or losses fall into a particular taxation year, this can often be accomplished by deferring the disposition of the relevant asset until that period. This means that gains can often be deferred, perhaps until retirement, when the taxpayer may be in a lower tax bracket.

8-167. Other examples of tax planning would include selling securities with accrued losses in order to offset gains realized earlier in the taxation year, deferring the sale of an asset with a significant capital gain until after the year end and delaying the receipt of a portion of the proceeds of disposition to claim capital gains reserves.

8-168. Tax planning for capital gains is more complex if an individual owns small business corporation shares or a farm or fishing property. This is due to the fact that such properties may be eligible for the lifetime capital gains deduction. Additional complications result from the application of capital losses, particularly with respect to carry overs of such amounts. These issues are discussed in Chapter 11.

**We suggest you work Self Study Problems Eight-14 to Eight-18 at this point.**

**Additional Supplementary Self Study Problems Are Available Online.**

# Key Terms Used In This Chapter

8-169. The following is a list of the key terms used in this Chapter. These terms, and their meanings, are compiled in the Glossary located at the back of the Study Guide.

| | |
|---|---|
| Adjusted Cost Base | Listed Personal Property |
| Allowable Capital Loss | Personal Use Property |
| Capital Asset | Principal Residence |
| Capital Cost | Proceeds Of Disposition |
| Capital Gain | Real Property |
| Capital Gains Reserve | Recapture Of CCA |
| Capital Loss | Replacement Property Rules |
| Deemed Disposition | Reserve |
| Deeming Rules | Rollover |
| Disposition | Small Business Corporation |
| Election | Superficial Loss - ITA 54 |
| Emigration | Taxable Canadian Property |
| Former Business Property | Taxable Capital Gain |
| Identical Property Rules | Terminal Loss |
| Involuntary Disposition | Undepreciated Capital Cost (UCC) |

# References

8-170. For more detailed study of the material in this Chapter, we would refer you to the following:

| | |
|---|---|
| ITA 38 | Taxable Capital Gain And Allowable Capital Loss |
| ITA 39 | Meaning Of Capital Gain And Capital Loss |
| ITA 40 | General Rules |
| ITA 41 | Taxable Net Gain From Disposition Of Listed Personal Property |
| ITA 42 | Dispositions Subject To Warranties |
| ITA 43 | General Rule For Part Dispositions |
| ITA 44 | Exchanges Of Property |
| ITA 44.1 | Definitions (Eligible Small Business Shares) |
| ITA 45 | Property With More Than One Use |
| ITA 46 | Personal Use Property |
| ITA 47 | Identical Properties |
| ITA 49 | Granting Of Options |
| ITA 53 | Adjustments To Cost Base |
| ITA 54 | Definitions (Capital Gains) |
| ITA 69 | Inadequate Considerations |
| ITA 70 | Death Of A Taxpayer |
| ITA 73 | Inter Vivos Transfer To Individuals (e.g., Transfers To A Spouse) |
| IC 88-2 | General Anti-Avoidance Rule — Section 245 Of The Income Tax Act |
| S1-F3-C2 | Principal Residence |
| S1-F5-C1 | Related Persons And Dealing At Arm's Length |
| S3-F3-C1 | Replacement Property |
| IT-95R | Foreign Exchange Gains And Losses |
| IT-96R6 | Options Granted By Corporations To Acquire Shares, Bonds Or Debentures And By Trusts To Acquire Trust Units |
| IT-102R2 | Conversion Of Property, Other Than Real Property, From Or To Inventory |
| IT-159R3 | Capital Debts Established To Be Bad Debts |
| IT-259R4 | Exchanges Of Property |
| IT-262R2 | Losses Of Non-Residents And Part-Year Residents |
| IT-264R | Part Dispositions |
| IT-268R4 | Inter Vivos Transfer Of Farm Property To A Child |
| IT-381R3 | Trusts — Capital Gains And Losses And The Flow Through Of Taxable Capital Gains To Beneficiaries |
| IT-387R2 | Meaning Of Identical Properties (Consolidated) |
| IT-403R | Options On Real Estate |
| IT-451R | Deemed Disposition And Acquisition On Ceasing To Be Or Becoming Resident In Canada |
| IT-456R | Capital Property — Some Adjustments To Cost Base |
| IT-479R | Transactions In Securities |
| IT-491 | Former Business Property |

# Problems For Self Study (Online)

To provide practice in problem solving, there are Self Study and Supplementary Self Study problems available on MyLab Accounting.

Within the text we have provided an indication of when it would be appropriate to work each Self Study problem. The detailed solutions for Self Study problems can be found in the print and online Study Guide.

We provide the Supplementary Self Study problems for those who would like additional practice in problem solving. The detailed solutions for the Supplementary Self Study problems are available online, not in the Study Guide.

The .PDF file "Self Study Problems for Volume 1" on MyLab contains the following for Chapter 8:

- 18 Self Study problems,
- 9 Supplementary Self Study problems, and
- detailed solutions for the Supplementary Self Study problems.

# Assignment Problems

(The solutions for these problems are only available in the solutions manual that has been provided to your instructor.)

### *Assignment Problem Eight - 1*

***(Identical Properties)***

Miss Wells has purchased the shares of two companies over the years. Each company has only one class of shares. Purchases and sales of shares in the first of these companies, Memo Inc., are as follows:

| | |
|---|---|
| February, 2015 purchase | 60 @ $24 |
| November, 2016 purchase | 90 @ 28 |
| April, 2017 purchase | 45 @ 30 |
| October, 2017 sale | (68) @ 36 |
| September, 2019 purchase | 22 @ 26 |
| November, 2019 sale | (53) @ 40 |

Purchases and sales of shares in the second company, Demo Ltd., are as follows:

| | |
|---|---|
| April, 2018 purchase | 200 @ $24 |
| December, 2018 purchase | 160 @ 33 |
| July, 2019 sale | (260) @ 36 |

**Required**:

A. Determine the cost to Miss Wells of the Memo Inc. shares that are still being held on December 31, 2019.

B. Determine the taxable capital gain resulting from the July, 2019 disposition of the Demo Ltd. shares.

### *Assignment Problem Eight - 2*

***(Identification Of Capital Gains And Reserves)***

In early 2017, Cyndey Walters received a $2 million settlement in a sexual assault case. She immediately quit her job as a plumber for a construction company. She searched for rundown houses in her neighbourhood that she could buy at a low price. Her objective was to bring her houses up to code, i.e., in accordance with building regulations, and rent them to the women and their children currently being housed in the local overcrowded shelter.

Cyndey charged just enough rent to cover the expenses of each house. By March, 2018, she owned five houses that were rented to five grateful families. She continued working part time as a plumber while she took courses towards a degree in social work.

Cyndey came from a large family, many members of which were involved in the construction business. She called on her family for help when her tenants needed services and they gave her a family discount on their invoices.

In June, 2019, she learned through her uncle (an undertaker) that the owner of two low rise apartment buildings in the neighbourhood had died. They were vacant and in very poor condition. The executor of the estate, the 90 year old brother of the deceased, wanted a quick sale. Cyndey offered $250,000 cash for the two buildings and the large parking lot between them. The offer was immediately accepted. She believed the land alone was worth more than $250,000 and was surprised the executor did not make a higher counteroffer.

As this was a much larger project than the single family homes she had worked on before, she enlisted the aid of her father, an experienced contractor. He agreed to be the general contractor for the project. In late July, 2019, he suffered a massive heart attack while working late at night over the project's plans. He subsequently died.

In August, 2019, a major software company announced it was going to move its Canadian headquarters into the neighbourhood within 2 years.

In September, 2019, Cyndey received an unsolicited offer of $1.5 million for her property. The purchaser intends to construct a luxury condo building to house the newly hired workers.

The offer requires Cyndey to take back a $1 million first mortgage on the property. The mortgage will be repaid in 4 annual instalments of $250,000 each, beginning in 2020. Because her mother blames Cyndey for causing the heart attack that killed her father, she reluctantly accepts the offer. She hopes the sale will ease the family conflict.

In November, 2019, Cyndey begins to receive unsolicited cash offers for her rental houses. The offers are all for more than double what she paid for the houses.

**Required:** Cyndey has sought your advice as the appropriate tax treatment of the sale transaction. Provide the required advice.

## Assignment Problem Eight - 3

### (Warranties, Bad Debts, and Reserves)

For a number of years, Lester Wayne has owned a large tract of undeveloped land near Windsor, Ontario. He had acquired this land at a cost of $1,585,000, all of which was paid in cash.

Despite the dwindling activity in its automobile plants, the relatively mild climate of the Windsor area has encouraged population growth in the surrounding region. Because of this, a local developer has offered Lester $3,650,000 for his land, expecting to turn the area into 100 building lots for large, single family homes. The terms of the offer are as follows:

- An initial payment of $650,000 will be made on January 1, 2019.
- Annual instalments of $1,000,000 will be made on January 1, 2020, January 1, 2021, and January 1, 2022.
- Interest on the outstanding balance will be paid to Lester on December 31 of each of the years 2019 through 2022. It will be calculated at a rate of 5 percent of the balance outstanding on January 1 of each year.

Also, because of the high level of risk involved in the project, Lester is asked to provide a warranty. Specifically, the builder would like to have a payment of $15,000 for each lot that remains unsold on July 1, 2021. Lester agrees to this arrangement.

The required instalment payments due on January 1, 2020 and 2021, as well as the interest due at the end of the years 2019 and 2020 are paid as per agreed upon schedule. However, the developer is not successful in his promotion of the lots. As a result, on July 1, 2021, 40 of the lots remain in his inventory. Lester makes the required warranty payment of $600,000 [(40)($15,000)].

The developer is unable to sell any additional lots after July 1, 2021. Because of these difficulties, he does not make the required interest payment on December 31, 2021, or the required instalment due on January 1, 2022.

When Lester does not receive these payments and grows suspicious of the developer's excuses, he tries very hard to locate the developer. In July, 2022, he finally accepts that this individual has disappeared, leaving many angry creditors. At this point, Lester writes off the interest that was accrued on December 31, 2021, as well as the remaining instalment that was due on January 1, 2022.

During the years 2019 through 2022, Lester does not have any capital gains or losses, other than those related to the sale of this tract of land. He has pension and investment income totalling more than $80,000 each year.

**Required:** Calculate the tax effects of the transactions that took place during 2019 through 2022 on Lester Wayne's Net Income For Tax Purposes.

### *Assignment Problem Eight - 4*

***(Capital Gains Reserves)***

Several years ago, Ms. Nina Stark acquired an existing building to be used in her unincorporated business. The total cost of the property was $2,300,000, with $800,000 of this amount representing the estimated fair market value of the land on which the building was situated.

She has decided that, in order to improve her cash position, she would like to sell this building and move her operations to leased premises. On January 1, 2019 the building is sold for $2,800,000. Of this total $900,000 reflects the value of the land on which the building is situated. At this time, the UCC balance in Class 1 is $1,248,019. The building was the only asset in Class 1.

The terms of the sale require the buyer to make a down payment at the time of purchase, with the remaining balance payable on January 1, 2021. No payments are required in 2020. Interest on the outstanding balance is paid on December 31 at an annual rate of 6 percent.

Nina plans to use reserves to defer the payment of taxes on the capital gain which results from this sale.

**Required:** Indicate the tax effects of these transactions on Nina's Net Income For Tax Purposes for the years 2019, 2020, and 2021, assuming:

A. that the down payment was equal to 10 percent of the sales price.
B. that the down payment was equal to 30 percent of the sales price.

### *Assignment Problem Eight - 5*

***(Capital Gains Reserves)***

Several years ago, Erin acquired two tracts of land located near the city of Richmond, British Columbia. These tracts cost $325,000 and $430,000.

His original intention was to develop the tracts into two subdivisions of 40 lots each. However, because of the ongoing responsibilities associated with his position at the University Of British Columbia, he has not found time to undertake this project. Even though he has made no effort to market the tracts, he receives two very attractive offers from a developer to purchase the tracts. The terms of the two offers are as follows:

**Tract 1** The offer for the $325,000 tract was $879,000. The terms require a down payment on January 1, 2019 of $395,550 (45 percent of the sales price), with the balance due on December 31, 2022. Interest, calculated at an annual rate of 6 percent of the beginning of the year balance, is due on December 31 of 2020, 2021, and 2022.

**Tract 2** The offer for the $430,000 tract was $1,000,000. The terms require a down payment on January 1, 2019 of $100,000. Further payments of $300,000 each will be required on December 31 of 2020, 2021, and 2022. Interest, calculated at an annual rate of 6 percent of the beginning of the year balance, is due on December 31 of 2020, 2021, and 2022.

Erin decides to accept both of these offers.

**Required**: Determine the amounts that will be included in Erin's Net Income For Tax Purposes as a result of these transactions. Show the effect for each of the years 2019, 2020, 2021, and 2022 separately. Your answer should include taxable capital gains and interest receipts.

## Assignment Problem Eight - 6

### *(Capital Gain Reserves)*

Mr. Rhodes purchased a large tract of land on the edge of Edmonton 15 years ago for $750,000. It was sold during April, 2019 to a developer for $2,500,000. He receives a down payment of $625,000 (25%) and accepts a 25 year, 8 percent mortgage for the balance of $1,875,000. The payments on this mortgage begin in the second year and require the repayment of $75,000 (3% of the proceeds of disposition) per year in principal.

Mr. Rhodes wishes to defer taxes through the use of reserves to the extent possible.

**Required:** Calculate the capital gains taxation effects of this sale, assuming that Mr. Rhodes deducts the maximum capital gains reserve in 2019 and subsequent years.

## Assignment Problem Eight - 7

### *(Principal Residence Designation)*

Ms. Annalisa Philson has been married to Spiro Philson for over 10 years. While Annalisa is 32, her husband is 75 and has been in poor health for a number of years. They live in a home in Ottawa which Spiro purchased as a wedding gift for her in 2008 for $628,000. Annalisa is the sole owner of this property.

On a 2010 business trip to Calgary, Annalisa met Arnold Schwarz, a fitness trainer at the hotel where she stayed. The attraction was immediate and mutual and Annalisa has traveled regularly to Calgary to spend time with Arnold since then. In 2011, Annalisa purchased a condo in downtown Calgary for $325,000 and gave Arnold a key. In every year since its purchase, she has spent considerable time with Arnold in this property.

The year 2019 turned out to be an Annus Horribilis for Annalisa. To begin, her husband obtained well documented proof of her infidelity after hiring a private investigator. As a result, he moved out of the Ottawa home and removed her from his will where she had been the sole beneficiary of his considerable estate.

To make matters worse, on her last visit to Calgary, Arnold informed her that, at 32, she was now too mature for his tastes and he had made other living arrangements.

These events have left Annalisa determined to change her life style. She decided to sell both properties and move into a religious community that requires a vow of celibacy from all of its residents.

As Annalisa has spent time in each property during every year of ownership, either one can be designated as her principal residence for any given year of ownership.

Both properties are sold quickly in 2019, with the Ottawa home going for $724,000 and the Calgary condo selling for $415,000. The real estate fees on each sale are 4 percent of the sales price. After receiving the proceeds, Annalisa decides to go on one last trip to Cancun before starting her new life.

**Required:** Describe how the residences should be designated in order to accomplish Annalisa's goal. In addition, calculate the total amount of the gain that would arise under the designation that you have recommended.

### Assignment Problem Eight - 8

#### (Personal Use Property)

Mr. Firenza owns a number of personal assets, all of which were acquired while he was a resident of Canada. As he plans to spend the next 5 years travelling the globe, he will be converting most of his possessions to cash. The assets he will be selling in the current year can be described as follows:

- He owns a vintage automobile which has been restored to like new condition. He acquired the vehicle for $42,000 and has spent $135,000 on the restoration process. He estimates the current fair market value of the automobile to be $320,000.
- He has an extensive coin collection which has a current fair market value of $23,500. The total cost of all of the coins is $17,600. He believes that the coins can be disposed of without incurring any selling costs.
- At her death, his mother left him a rare 17th century manuscript. His mother had paid $4,000 for the manuscript and, at the time of her death, it was estimated that its fair market value was $42,000. However, since the time of the bequest, several other copies of this manuscript have been found and, as a consequence, its value has decreased to $8,500.
- Mr. Firenza owns a Lawren Harris oil painting which he acquired for $275,000. While he believes it could be sold for $350,000, the auction house will charge a commission of 20 percent of the sales price.
- Mr. Firenza owns a sailboat which cost $162,000. He estimates that its current fair market value, net of selling costs would be $123,000.
- Mr. Firenza has an antique desk that he acquired for $600. He believes that it could be sold for $2,200 and that no selling costs would be incurred.

**Required:** Mr. Firenza has asked you to determine the amount that would have to be included in his Net Income For Tax Purposes if all of these assets were sold for their estimated values. Indicate any amounts that may be available for carry over to other years.

### Assignment Problem Eight - 9

#### (Capital Gains On Foreign Securities)

Richie Desjardins is a resident of Canada. On September 4, 2015, he receives an inheritance of $200,000 U.S. dollars (US$, hereafter) from an uncle who was a U.S. resident. The funds are immediately transferred into his brokerage account and used to purchase 4,500 shares of Facehow Industries, a tech company that is traded on the New York Stock Exchange. The shares are acquired at US$43 per share, a total investment of US$193,500. The remaining US$6,500 is left in the brokerage account.

The shares pay an annual dividend of US$2.05 per share. Richie receives the dividends of US$9,225 [(4,500)(US$2.05)] on the following dates:

June 1, 2016
June 1, 2017
June 1, 2018

All of these funds are left in his brokerage account and his account does not earn interest.

On July 13, 2018, all of the Facehow shares are sold for US$35 per share, a total of US$157,500. The US$157,500 balance is left in the brokerage account until January 31, 2019, at which time they are converted, along with the unused US$6,500 balance and the accumulated dividends, into Canadian dollars (C$, hereafter). He withdraws all the funds in his brokerage account on June 6, 2019 in order to purchase a house.

Assume relevant exchange rates between the Canadian dollar and the U.S. dollar are as follows:

| | |
|---|---|
| September 4, 2015 | US$1.00 = C$0.98 |
| June 1, 2016 | US$1.00 = C$1.03 |
| June 1, 2017 | US$1.00 = C$1.09 |
| June 1, 2018 | US$1.00 = C$1.26 |
| July 13, 2018 | US$1.00 = C$1.28 |
| January 31, 2019 | US$1.00 = C$1.35 |
| June 6, 2019 | US$1.00 = C$1.40 |

**Required:** Calculate the minimum amount that will be included in Mr. Desjardins' Net Income For Tax Purposes for each of the years 2015 through 2019.

## Assignment Problem Eight - 10

### (Changes In Use - CCA)

Miss Coos purchased a building to be used as her personal residence for a cost of $360,000. Of this total, it is estimated that the value of the land is $90,000 and the value of the building is $270,000.

After living in it for 2 years, on January 1, 2017 a portion of this residence was converted to an office and rented to a local accountant for $1,200 per month. At the time of the conversion, the fair market value of the building was $360,000. The fair market value of the land is unchanged. Based on the amount of floor space allocated to the office, Miss Coos indicates that 30 percent of the building was converted into office space at this time.

On January 1, 2019, the office was rented by a new tenant who did not require the same amount of floor space as the previous tenant. As a result, one room was converted back to personal use. This room contained 10 percent of the total floor space, and the fair market value of the building was $420,000 at this time. The market value of the land remains at $90,000.

**Required:** What is the maximum CCA that can be deducted in 2017, 2018, and 2019? In addition, indicate any capital gains or losses that will result from the changes in use.

## Assignment Problem Eight - 11

### (Departure From Canada)

Elly Councill is 57 years old and has been a Canadian resident since birth. Having become fed up with Halifax winters, she decides to move to California. Ms. Councill has come to you for advice prior to leaving Canada for good.

She will depart on January 1, 2019 and, on that date, she owns the following assets located in Canada:

| | Adjusted Cost Base | Fair Market Value |
|---|---|---|
| Oil Painting | $ 33,000 | $ 38,000 |
| Coin Collection | 11,000 | 4,000 |
| Shares In Enbridge (A Canadian Public Company) | 42,000 | 68,000 |
| Shares in Veresan (A Canadian Public Company) | 63,000 | 52,000 |
| Vacant Land | 87,000 | 108,000 |
| Personal Residence | 220,000 | 342,000 |
| Power Boat (Recreational Use Only) | 72,000 | 56,000 |
| Shares In Councill Ltd. (A CCPC) | 16,000 | 48,000 |

Assume she will make no elections related to her departure from Canada.

**Required**: Determine the amount of the taxable capital gain or allowable capital loss that Ms. Councill will report in her Canadian income tax return for 2019 as a result of her departure from Canada.

### *Assignment Problem Eight - 12*

***(Deferral On Small Business Investments)***

In both of the following Cases, the original shares have been held for more than a year.

**Case A** On March 31, 2019, Harold sells his common shares in Corporation A, which is an eligible small business corporation. His proceeds of disposition are $100,000 and his capital gain is $60,000. On July 1, 2019, Harold invests $90,000 in common shares of Corporation B, which is a new eligible small business corporation.

**Case B** On November 6, 2018, Kate disposes of common shares in Corporation C, which is an eligible small business corporation. Her proceeds of disposition are $1,000,000 and she realizes a capital gain of $600,000. On February 1, 2019, Kate acquires common shares in Corporation D, which is also an eligible small business corporation, at a cost of $1,000,000.

**Required:** For both Cases, determine the maximum permitted capital gains deferral, as well as the adjusted cost base of the replacement shares.

### *Assignment Problem Eight - 13*

***(Voluntary Dispositions - With ITA 44(6) Election)***

Canco Inc., a publicly traded Company, has operated out of a building in Hamilton for many years. Its major assets are as follows:

**Land And Building** The building was constructed for the Company at a total cost of $2,300,000. It is the only asset in the Company's Class 1. The January 1, 2019 UCC balance in this Class is $1,105,000. The building is situated on land that the Company purchased for $250,000.

**Class 8 Assets** All of the Company's equipment, furniture and fixtures falls into Class 8. The assets have a capital cost of $230,000. The January 1, 2019 UCC balance of Class 8 is $178,645.

Canco operated a retail outlet for its products, various sports clothing, from the front half of the building which is situated on a busy major street. Over the last two years, the sales from the store have drastically decreased while the online sales of its products have taken off.

Canco has made the decision to close the store and focus on its online sales. As a result, they have decided to move to a more appropriate site in Sudbury.

In late November, 2019, Canco lists the building for sale and almost immediately gets an offer which they accept. The total proceeds for the land and building are $3,200,000, with $800,000 of this total reflecting the value of the land. The remaining $2,400,000 is allocated to the building. The Class 8 assets are sold to the new owners for $200,000.

In early January, 2020, Canco completes the purchase of a suitable Sudbury property for $3,080,000. Based on estimates, $2,480,000 is allocated to the building and $600,000 is allocated to the land. As it is not a new building, it does not qualify for the enhanced CCA rate for Class 1.

The Class 8 equipment and furniture is replaced at a cost of $275,000. Canco's computer equipment is stored and moved to the new location.

The Company's tax year ends on December 31, 2019, and it does not own any buildings or Class 8 assets on this date. There was a problem with the vendor's documents which delayed the purchase until 2020. Canco would like to minimize any capital gains or recapture resulting from the sale of the Hamilton property.

**Required:**

A. For the disposition of each property, indicate the tax effects that would be included in the Company's 2019 tax return.

B. Indicate how these tax effects could be altered in an amended 2019 return by using the elections available under ITA 44(1) (to defer capital gains) and ITA 13(4) (to defer recapture), but without the use of the election under ITA 44(6) (to reallocate the proceeds of disposition). Also indicate the adjusted cost base and, where appropriate, the UCC of the replacement properties, subsequent to the application of the ITA 44(1) and ITA 13(4) elections.

C. Indicate the maximum amount of any reduction in income in the amended 2019 Net Income For Tax Purposes that could result from the use of the ITA 44(6) election and calculate the UCC balance that would result from electing to use this amount. Should the Company make the election? Explain your conclusion.

## Assignment Problem Eight - 14

### *(Involuntary Dispositions - No ITA 44(6) Election)*

Kontex Ltd. is a Canadian public company with a taxation year that ends on December 31. The Company operates out of a single building which was acquired several years ago at a cost of $1,782,000. Of this total, $400,000 is allocated to the land, with $1,382,000 going to the building. The building is the only asset in Class 1 and, on January 1, 2018, the balance in this Class is $985,926.

On October 1, 2018, the building is completely destroyed in a fire that was started by a disgruntled former executive. While the Company could rebuild on the site of the destroyed building, it expects significant growth in the next few years and would like to have a larger building in which to carry on its operations.

Given this, the Company sells the site for $550,000 on December 5, 2018 and begins to search for a replacement site. As it does not appear that the Company had any involvement in the starting the fire, on December 1, 2018, the Company receives insurance proceeds equal to the $1,600,000 fair market value of the building.

A replacement building is acquired on July 15, 2019 at a cost of $2,500,000, of which $1,700,000 is allocated to the building and $800,000 to the land. It is a new building that will be used 100 percent for non-residential purposes, none of which is manufacturing. It is the intent of Kontex Ltd. to keep this building in a separate Class 1.

**Required:**

A. Indicate the tax consequences of the involuntary disposition that will be reported in the Company's tax return for the year ending December 31, 2018.

B. Indicate the changes that will be reported in the amended return for the year ending December 31, 2018, provided the Company makes elections under ITA 13(4) (to defer recapture) and ITA 44(1) (to defer capital gains). In addition, determine the capital cost and UCC for the replacement assets, subsequent to the application of these elections.

C. Calculate the maximum CCA that Kontex will be able to claim for the building in the taxation year ending December 31, 2019, assuming the Company makes the elections under ITA 13(4) and ITA 44(1).

### *Assignment Problem Eight - 15*

#### *(Comprehensive Tax Payable Covering Chapters 1 to 8)*

#### *Family Information*

Owen Winehouse is 51 years old and has been married to Arlene Winehouse for over 25 years. Having made his fortune through a wildly successful initial public offering, he devotes most of his time to mentoring young entrepreneurs and participating in volunteer activities.

Arlene is also very active in various charitable causes. For the 2019 taxation year, she has Net Income For Tax Purposes and Taxable Income of $7,650.

Owen and Arlene have two daughters:

> **Martha** is 14 years old and is in good health. She has income from part time summer jobs of $5,620.
>
> **Marlene** is 19 years old. She is in good health and attends university on a full time basis for 9 months of the year. Owen pays all of her costs including tuition of $11,400, textbook costs of $1,600, and residence fees of $10,400. Marlene has no income of her own. Given this, she has agreed to transfer her tuition credit to her father.

Owen's father, Philip lives with the family. He is 73 years old and in good health. His 2019 Net Income For Tax Purposes totals $17,300.

#### *Other Information*

Information relevant to Owen's 2019 tax return follows.

1. During 2019, Owen received eligible dividends from Canadian public companies in the amount of $42,400.

2. For several years Owen has owned 100 percent of the shares of an eligible small business corporation. The adjusted cost base of these shares is $520,000. On January 1, 2019, these shares are sold for $600,000. Assume none of the gain is eligible for the lifetime capital gains deduction. Of the total proceeds, $500,000 is immediately invested in another eligible small business corporation. During 2019, the new small business corporation paid non-eligible dividends of $22,000.

3. The residence occupied by Owen and Arlene was purchased in 2004 for $320,000. As their space needs have grown considerably, particularly since Philip has moved in, they have decided to replace this property. It is sold during February, 2019 for $375,000. Selling costs, including real estate commissions, total $20,000. Their new residence, purchased at the beginning of 2019, cost $458,000.

4. Owen purchased a cottage for the family's use in 2009 for $215,000, of which $65,000 reflects the cost of the land on which the cottage is situated. The family has made some use of the cottage in every subsequent year. Anticipating spending more time in their new and larger city residence, Owen decides to convert the cottage to a rental property. On

January 3, 2019, it is estimated that the fair market value of the property is $235,000, of which $75,000 can be allocated to the land. As Owen plans to take CCA on this property, he does not elect under ITA 45(2) to have the property continue as his principal residence.

In addition, Owen spends $42,000 furnishing the cottage. All of the furnishings are Class 8 assets.

On March 1, 2019, it is rented for $4,000 per month for the remainder of the year. Expenses, other than CCA, total $23,600 for March 1 to December 31, 2019.

5. In 2018, Owen purchased 1,000 units of ReCan Investment Trust at $40 per unit. In July, 2019, these units make a distribution of $2 per unit of which $0.75 is designated as a return of capital. All of this distribution is re-invested in ReCan units at a price of $42 per unit. No other distributions are made during the year. In December, 2019, all of the units are sold at a price of $39 per unit.

6. In 2018, Owen sold a piece of undeveloped land for $125,000. This land had been purchased several years before for $100,000. While Owen's original intent was to construct a backwoods retreat on the site, he had not found the time to improve the land and decided the offer of $125,000 was too attractive to resist. Owen had paid a total of $2,000 in property taxes on the land prior to its sale. The terms of the sale required the buyer to provide a down payment of $37,500, with the remaining balance to be paid in 2020. Owen uses reserves to defer as much of his gain as possible.

7. For several years, Owen has been interested in a French common stock Debit Agricole (DA). The stock trades in Euros (€) and Owen's first purchase of 1,000 shares was made on October 1, 2016 for €14.00 per share. Assume he acquired the Euros at a rate of €1 = $1.57. Subsequent transactions were as follows:

| Date | Quantity Purchased (Sold) | Price Per Share (€) | Assumed Exchange Rate (Canadian $) |
|---|---|---|---|
| November 4, 2017 | 300 | €14.50 | $1.55 |
| January 6, 2018 | (400) | 15.00 | 1.54 |
| June 24, 2019 | 600 | 15.50 | 1.51 |

On December 2, 2019, he sells all of his shares for €13.00 per share. Assume at this time €1 = $1.50. The Euros are immediately converted into Canadian Dollars.

8. As Owen will no longer have use of his cottage, he decides to sell his vintage power boat. He had purchased this boat several years ago in damaged condition for $10,000. He subsequently spent $24,627 restoring it to mint condition. As a result, he was able to sell it for $50,000 during 2019.

9. During 2019 he sold his stamp collection for $12,000. The total cost of the collected stamps was $8,000. He also sold an oil painting for $700. This painting, which he had always hated, had been a gift from Arlene's mother. At the time of the gift, the painting had a fair market value of $4,000.

10. During 2019, Owen spends 225 hours volunteering in a search and rescue program sponsored by the province in which he lives. He receives no compensation for this work.

11. During 2019, Owen makes contributions to registered charities in the amount of $5,000.

12. During 2019, Owen pays for medical services provided to various family members as follows:

| | |
|---|---|
| Dental Work (Root Canal) For Arlene | $1,500 |
| Dental Work (Cavities) For Martha | 875 |
| Physiotherapy (Back Pain) For Arlene | 1,300 |
| Surgery (Tummy Tuck) For Owen | 1,800 |
| Total | $5,475 |

**Required:** Determine Owen's 2019:

A. Minimum Net Income For Tax Purposes.

B. Minimum Taxable Income.

C. Minimum federal Tax Payable.

Ignore GST/HST considerations.

### Assignment Problem Eight - 16

#### (Comprehensive Case Covering Chapters 1 to 8)

#### Family Information

Ms. Jasperina Johns is 45 years of age and is divorced from her husband. She has one son, Louis who is 12 years old and is sufficiently disabled that he qualifies for the disability tax credit. Louis has 2019 Net Income For Tax Purposes of $1,200 which is interest income from an inheritance.

Her mother, Jackie lives with them and provides care for Louis. She has a Net Income of over $150,000. Jasperina has offered to pay her for her services, but Jackie has refused to accept any payment.

#### Employment Information

Jasperina is the Chief Financial Officer of a large public corporation and has an annual salary of $252,000. Her employer offered her various choices in extra compensation and she chose the health care package. As a result she does not have any non-reimbursable medical or dental costs. During 2019, the plan reimbursed her $18,425 for medical and dental fees she paid for herself and Louis.

Her employer withholds the following amounts from her income:

| | |
|---|---:|
| RPP Contributions | $3,200 |
| EI | 860 |
| CPP | 2,749 |

Jasperina's employer makes a matching contribution to her RPP of $3,200.

Jasperina's employer reimbursed her $4,900 for three evening courses that she attended at a local college during 2019. They were accounting, tax and human resource courses taken at the request of the president of the Company.

Every employee received a Fitbit activity tracker, T-shirt, cap, sunglasses and water bottle with the company name and logo in their Christmas basket. The basket was valued at $300.

#### Business Income

In addition to her employment income, Jasperina has income from an unincorporated business that provides counselling and training for parents who have disabled children.

In 2017, Jasperina rented a small commercial condo to run her business from. As revenues for her business have increased rapidly, on February 1, 2019 she purchased a much larger new property in the same complex for $368,000. She obtained a mortgage from the bank for $175,000 to finance the purchase. She had to spend $78,200 on renovations to make the new condo suitable for her purposes. This included $11,200 to make the premises more handicap accessible by enlarging the washrooms, adding wheelchair ramps and installing handrails. Since the disability related modifications were done and billed in late December, Jasperina did not take any amortization for accounting purposes on the $11,200 for 2019.

She moved into her new property on October 31, the day her lease expired.

On January 1, 2019 Jasperina owned Class 8 assets with a UCC balance of $16,888. The new tenants of the rental unit purchased various Class 8 assets from her for $5,000. The assets had a capital cost of $23,000. The remainder of her Class 8 assets were moved to the new property.

During 2019, Jasperina acquired additional Class 8 assets at a cost of $28,000.

For 2019, the net income of this business, determined using generally accepted accounting principles, was $133,656. Included in this figure were the following:

| | |
|---|---|
| Amortization Expense | $16,900 |
| Business Meals And Entertainment | 1,500 |
| Property Taxes, New Unit - February 1 to October 31 | 3,600 |
| Property Taxes, New Unit - November 1 to December 31 | 900 |
| Interest On Mortgage - February 1 to October 31 | 8,100 |
| Interest On Mortgage - November 1 to December 31 | 1,800 |
| Rent, Old Unit - February to October | 18,000 |

### *Other Information*

1. During 2019, Jasperina received eligible dividends of $45,123.
2. At the beginning of 2019, Jasperina purchased 2,000 units of the Schwartz Income Trust for $10 per unit. During 2019, the trust had a distribution of $3.20 per unit, all of which was return of capital. Jasperina had all of this distribution invested in additional units at $15 per unit. In December, 2019, all of her Schwartz units were sold for $19 per unit.
3. Jasperina's late father was an amateur painter who didn't sell a single painting while he was alive. He gave Jasperina a number of his paintings over the years. Shortly after his death, he was "discovered" and his paintings were in demand. During 2019, she sold two of his large paintings for $10,000 each. The electrician doing the renovations fell in love with one of his other paintings. She offered to trade $10,000 in services for it and Jasperina accepted the offer. The $10,000 is included in the $67,000 renovations total.
4. Jasperina inherited a ski chalet from her father. At his death, the chalet had an adjusted cost base of $150,000 and a fair market value of $165,000. The estimated value for the land included in both figures was $40,000. In December, 2018, she suffered a serious knee injury when she fell off a chair lift. Because of this, Jasperina decided to convert the property to a rental property. On January 1, 2019, the property was appraised for $280,000, including $66,000 for the land. During 2019, net rental income before the deduction of CCA equaled $8,820. Jasperina does not intend to designate the chalet as her principal residence in any of her years of ownership.
5. Jasperina also inherited a piece of land from her father. At his death, the land had an adjusted cost base of $57,000 and a fair market value of $233,000. Jasperina had owned the land with the intention of building a yoga retreat on the site when she found the time to design it. However, in 2019 she received an unsolicited offer for the property of $400,000. She accepted the offer and immediately received a payment of $150,000. The remaining $250,000 will be paid in 5 annual instalments of $50,000, beginning in 2020. Jasperina would like to use a capital gains reserve to defer as much 2019 taxation as possible.

**Required:** Calculate Ms. Jacks' minimum 2019 Net Income For Tax Purposes, her 2019 minimum Taxable Income, and her minimum 2019 federal Tax Payable. Ignore provincial income taxes, any instalments she may have paid during the year, any income tax withholdings that would be made by her employer, and GST/HST/PST considerations.

# CHAPTER 9

# Other Income, Other Deductions, And Other Issues

## Introduction

### Coverage Of Chapter 9

#### *Subdivisions d and e*

9-1. At this point, we have provided detailed coverage of all of the major components of Net Income For Tax Purposes. There are, however, certain inclusions and deductions that do not fit into any of the categories that we have described. For example, the receipt of a pension benefit cannot be categorized as employment income, business or property income, or a taxable capital gain. Correspondingly, an RRSP deduction cannot be related to any specific type of earned income and, as a consequence, cannot be specifically allocated to any of the previously described income categories. These miscellaneous inclusions and deductions will be given detailed attention in this Chapter.

9-2. In terms of the *Income Tax Act*, these miscellaneous sources and deductions are covered in two Subdivisions of Division B. Subdivision d, made up of Sections 56 through 59.1, is titled Other Sources Of Income. Subdivision e, made up of Sections 60 through 66.8, is titled Deductions in Computing Income.

9-3. Some of the items in Subdivision d are directly related to a corresponding item in Subdivision e. For example, Subdivision d requires the inclusion of spousal support paid, while Subdivision e provides for the deduction of these amounts by the individual making the payments. In contrast, many of the items in the two subdivisions are not related in any manner (e.g., the inclusion of death benefits under subdivision d).

9-4. Given this situation, our coverage of this material will be divided into three sections:

- The first section will deal with those Subdivision d inclusions that are not related to Subdivision e deductions, such as scholarships and workers' compensation.
- A second section will deal with those Subdivision e deductions that do not involve Subdivision d inclusions, such as moving costs and child care expenses.
- A third section will give attention to issues that involve Subdivision d inclusions that are related to Subdivision e deductions such as pension income splitting.

### Registered Savings Plans

9-5. As you are likely aware, Canadian taxpayers have access to a number of registered savings plans (e.g., registered retirement savings plans and registered education savings plans). While most of the inclusions and deductions related to these plans are found in subdivisions d and e, the rules related to these plans are complex and involve other components of the *Income Tax Act*.

9-6. Because of this complexity, our coverage of these plans will be divided between this Chapter 9 and a subsequent Chapter 10 which will provide general coverage of retirement savings. More specifically, in this Chapter we will cover the following plans:

- Registered Education Savings Plans (RESPs);
- Tax Free Savings Accounts (TFSAs); and
- Registered Disability Savings Plans (RDSPs) - Limited Coverage.

9-7. In Chapter 10, our coverage of registered savings plans will be extended to:

- Registered Pension Plans (RPPs);
- Registered Retirement Savings Plans (RRSPs);
- Registered Retirement Income Funds (RRIFs);
- Deferred Profit Sharing Plans (DPSPs); and
- Profit Sharing Plans (PSPs).

9-8. We are of the belief that this unusually extensive coverage of retirement savings vehicles is justified by the fact that these plans are perhaps the most important generally available form of tax planning that can be used by individuals. In addition, their complexity means that they are not well understood by most individuals, including some of the individuals providing professional advice in this area.

### Other Issues - Non-arm's Length Transfers, Death, Income Attribution

9-9. This Chapter 9 concludes our coverage of the major components of Net Income For Tax Purposes. The calculation of this value requires the application of a number of special rules, some of which we have covered in previous Chapters. However, there are others which we have not covered to this point. These include:

- Non-arm's length transfers of property;
- Deemed dispositions at the death of a taxpayer; and
- Attribution of income to non-arm's length parties.

9-10. This Chapter will include coverage of these additional rules.

# Other Income - Subdivision d Inclusions

## Pension Benefits - ITA 56(1)(a)(i)

9-11. ITA 56(1)(a)(i) requires that payments received from certain types of pension plans be included in the income of individuals. For many individuals, the major item here would be amounts received under the provisions of Registered Pension Plans. Also included would be pension amounts received under the *Old Age Security Act* (OAS), as well as any similar payments received from a province. In addition, benefits received under the Canada Pension Plan (CPP) or a provincial pension plan would also become part of the individual's Net Income For Tax Purposes.

9-12. CPP recipients can request that their CPP benefits be split and paid separately to a spouse or common-law partner based on the length of time the individuals have been living together relative to the length of the contributory period. As is discussed later in this Chapter, there is also legislation that allows most other types of pension income to be split between spouses or common-law partners. However, this latter type of pension split is implemented entirely in the tax returns and does not involve the actual payments being split.

## Retiring Allowances - ITA 56(1)(a)(ii)

9-13. ITA 56(1)(a)(ii) requires that retiring allowances be included in an individual's Net Income For Tax Purposes. ITA 248(1) defines these payments as follows:

> **"retiring allowance"** means an amount (other than a superannuation or pension benefit, an amount received as a consequence of the death of an employee or a benefit described in subparagraph 6(1)(a)(iv)) received
>
> (a) on or after retirement of a taxpayer from an office or employment in recognition of the taxpayer's long service, or
> (b) in respect of a loss of an office or employment of a taxpayer, whether or not received as, on account or in lieu of payment of, damages or pursuant to an order or judgment of a competent tribunal,
>
> by the taxpayer or, after the taxpayer's death, by a dependant or a relation of the taxpayer or by the legal representative of the taxpayer.

9-14. The term "retiring allowance" covers most payments on termination of employment. This includes rewards given for good service, payments related to early retirement (e.g., federal government buyout provisions) at either the request of the employee or the employer, as well as damages related to wrongful dismissal actions.

9-15. Within specified limits, amounts received as a retiring allowance for service prior to 1996 can be deducted if they are transferred to either a Registered Pension Plan (RPP) or a Registered Retirement Savings Plan (RRSP) within 60 days of the end of the year in which they are received. However, as this only applies to service prior to 1996, this provision declines in importance with each passing year.

## Death Benefits - ITA 56(1)(a)(iii)

9-16. Death benefits are included in the income of the recipient under ITA 56(1)(a)(iii). ITA 248(1) defines these death benefits as follows:

> **"death benefit"** means the total of all amounts received by a taxpayer in a taxation year on or after the death of an employee in recognition of the employee's service in an office or employment ...

9-17. When death benefits are received by a surviving spouse or common-law partner, the definition goes on to indicate that only amounts in excess of an exclusion of $10,000 are considered to be a death benefit for purposes of ITA 56(1)(a)(iii). This $10,000 exclusion would be available, even if the benefit was payable over a period of several years. A CPP death benefit is not eligible for the $10,000 exemption as it is not a death benefit paid in recognition of an employee's service.

9-18. The $10,000 exclusion is also available on payments to individuals other than a spouse or common-law partner, with the amount being reduced to the extent it has been used by the spouse or common-law partner. For example, if Ms. Reid dies and her employer pays a death benefit of $8,000 to her husband and an additional $8,000 to her adult son, the husband could exclude the entire $8,000 from income and the son could use the remaining $2,000 of the exclusion to reduce his income inclusion to $6,000.

9-19. Although death benefits are normally paid to the family of the deceased, it would appear that the $10,000 exclusion is available without regard to whom the death benefit is paid. This would suggest that an employer could pay any individual, including a related party, a $10,000 tax free death benefit on the death of any employee. Further, it would seem that an employer could repeatedly make such payments on the death of each of his employees.

## Income Inclusions From Deferred Income Plans - ITA 56(1)(h), (h.1), (h.2), (i), and (t)

9-20. Income inclusions from deferred income plans such as Registered Retirement Savings Plans (RRSPs), Registered Retirement Income Funds (RRIFs), and Deferred Profit Sharing Plans (DPSPs) do not fall into any of the major categories of income. Such amounts do not directly relate to employment efforts, business activity, ownership of property, or the disposition of capital assets. However, they clearly constitute income and, as a consequence, the *Income Tax Act* requires that payments from these various deferred income plans be included in the taxpayer's income.

9-21. The details of these various types of plans are discussed in Chapter 10 where we provide comprehensive coverage of retirement savings arrangements. While you should not expect to understand these plans at this stage, you should note that the various income inclusions that are related to these plans are included in Net Income For Tax Purposes under the provisions of Subdivision d of Division B. Brief descriptions of the various inclusions in this area are as follows:

**RRSP Withdrawals** All amounts that are removed from a Registered Retirement Savings Plan must be included in income under ITA 56(1)(h).

**Income Inclusions From Home Buyers' And Lifelong Learning Plans** If repayments to the RRSP are not made as per the required schedule for these plans (see Chapter 10), the specified amounts must be included in income. These amounts would be included in income under ITA 56(1)(h.1) and (h.2), respectively.

**Payments From DPSPs** Under ITA 56(1)(i), all amounts removed from a Deferred Profit Sharing Plan must be included in income.

**RRIF Withdrawals** The required minimum withdrawal, plus any additional withdrawals from Registered Retirement Income Funds, must be included in income under ITA 56(1)(h) and (t). Note that ITA 56(1)(t) would require the inclusion of the minimum withdrawal amount in income, even if the amount was not actually withdrawn.

## Scholarships And Prizes - ITA 56(1)(n)

9-22. ITA 56(1)(n) requires that all amounts received as scholarships, bursaries, grants, and prizes be included in income, to the extent that these amounts exceed the student's scholarship exemption under ITA 56(3). In most situations, these provisions completely exempt from income scholarships and prizes that are received in connection with:

- an education program in which the taxpayer is a qualifying student; and
- an elementary or secondary school education program.

9-23. Prior to 2017, ITA 56(3) referred to an "education program in which the taxpayer qualified for the education tax credit". However, with the elimination of the education tax credit, the reference was changed to an "education program in which the taxpayer is a qualifying student". ITA 118.6(1) notes that a qualifying student is enrolled as a full time student in a qualifying education program at a designated educational institution. In simplified terms, this refers to a university or college course of at least 3 weeks duration that requires at least 10 hours of effort per week.

9-24. In our material we will deal only with scholarships that are 100 percent exempt from income. Note that this has become a surprisingly technical area, resulting in the release of IT Folio S1-F2-C3, *Scholarships, Research Grants, And Other Education Assistance*. This complex 25 page document provides detailed coverage of such issues.

## Research Grants - ITA 56(1)(o)

9-25. Research grants are included in income under ITA 56(1)(o). The amount to be included is net of unreimbursed expenses related to carrying on the research work.

### Social Assistance And Workers' Compensation Payments - ITA 56(1)(u) And (v)

9-26. Payments received under various social assistance programs must be included in income under ITA 56(1)(u), while workers' compensation payments are included under ITA 56(1)(v). It is not, however, the intent of the government to tax these amounts. They are sometimes referred to as exempt income, as they have no net effect on Taxable Income. However, they are included in Net Income For Tax Purposes, a figure that is used in a variety of eligibility tests.

9-27. For example, to get the maximum Canada caregiver tax credit, the dependant's income must be less than a threshold amount ($16,766 for 2019). Since the policy is to reduce this credit in proportion to the dependant's income in excess of that amount, it is important that all types of income be included in the Net Income For Tax Purposes calculation. To accomplish this goal, social assistance and workers' compensation payments are included in the calculation of Net Income For Tax Purposes and then deducted in the calculation of Taxable Income.

## Other Deductions - Subdivision e Deductions

### CPP Contributions On Self-Employed Earnings - ITA 60(e)

9-28. As was noted in Chapter 3, individuals who are self-employed are required to contribute larger amounts to the CPP than individuals who are employees. The maximum employee CPP contribution for 2019 is $2,749. This payment is eligible for a tax credit equal to 15 percent of the amount paid, an amount of $412 for employees making the maximum contribution.

9-29. When an individual is an employee, the employer makes a matching contribution, resulting in a maximum total contribution of $5,498 [(2)($2,749)]. The additional contribution of 2,749 is fully deductible in the determination of the employer's Net Income For Tax Purposes.

9-30. Self-employed individuals who earn business income do not have an employer. However, the mechanics of the CPP system are such that an individual must have contributions that are the equivalent to those made by the employee/employer combination in order for that individual to receive the same benefits that would accrue to an employee. This goal is accomplished by having individuals with self-employed income make contributions that are the equivalent of both the employee and employer shares, a maximum of $5,498.

9-31. In order to put the individual with self-employed income on the same tax footing as an employee, the CPP contributions made on self-employed income are treated as follows:

- One-half of the individual's CPP contributions on self-employed income, to a maximum of $2,749, are used to generate a 15 percent credit against Tax Payable.
- The other one-half, to a maximum of $2,749, is deducted under Subdivision e (not in the calculation of business income) in the determination of Net Income For Tax Purposes.

### Moving Expenses - ITA 62

#### *General Rules*

9-32. ITA 62(1) indicates that a taxpayer can deduct moving expenses incurred as part of an "eligible relocation". The usual situations that would be considered eligible relocations can be described as follows:

- Taxpayers who move to a new work location (a new work location may or may not involve a new employer), either as:
  - employees,
  - independent contractors, or
  - after ceasing to be a full time student at a post-secondary institution.

- Taxpayers who move in order to commence full time attendance at a post-secondary institution and receive income from the educational institution that increases their Net Income For Tax Purposes.
- An unemployed taxpayer who moves to a new location in Canada to take up employment at that new location.

9-33. The definition also requires that the taxpayer's residence, both before and after the move, be in Canada. In addition, it specifies that the distance between the old residence and the new work location or institution be not less than 40 kilometres greater than the distance between the new residence and the new work location or institution. This distance is measured using the routes that would normally be traveled by an individual rather than "as the crow flies" (e.g., you can take the bridge, rather than swimming directly across the river).

9-34. The fact that there is no time limit on such moves has been supported by several court cases (see *Dierckens v. The Queen*, 2011 TCC 169).

> **EXAMPLE** In 2014, an individual assumes a new job which is 100 kilometres away from his current residence. For several years he commutes this distance on a daily basis. In 2019, he decides to move closer and acquires a residence that is more than 40 kilometres closer to his work location.
>
> **ANALYSIS** This would be an eligible relocation despite the fact that he has been working for the same employer at the same work location for more than 4 years.

9-35. Moving expenses can only be deducted against employment or business income received in a new work location, or from the educational institution (i.e., scholarships, research grants, etc. that increase Net Income For Tax Purposes). If the moving expenses exceed the income earned at the new location during the year of the move, any undeducted amount can be carried forward and deducted against income at the new location in any subsequent year. IT Folio S1-F3-C4, *Moving Expenses*, contains much information on this subject.

9-36. For employees, to the extent that the moving expenses are directly reimbursed by an employer, they cannot be claimed by the taxpayer. Note, however, if the employer provides a general allowance rather than an item by item reimbursement, the allowance must be included in income, thereby creating a situation in which the employee will be able to deduct the actual amount of expenses incurred.

9-37. As described in ITA 62(3), moving expenses include:

- Travel costs incurred to move the taxpayer and members of the household from the old residence to the new residence. These include vehicle costs and a reasonable amount expended for meals and lodging for the taxpayer and the taxpayer's family.
- The cost of transporting or storing household effects.
- The cost of meals and lodging for the taxpayer and the taxpayer's family near either the old or new residence for a period not exceeding 15 days. Note that, in measuring the 15 days, days spent while en route to the new location are not included.
- The cost of canceling a lease on the old residence.
- The selling costs of the old residence. Somewhat surprisingly, there is no restriction on claiming the selling costs to both reduce the capital gain on the old residence and also to increase moving expenses. Where the principal residence exemption can be used to eliminate 100 percent of the capital gain on the old residence, the selling costs would have no effect on the net taxable capital gain which would be nil.
- The legal and other costs associated with the acquisition of the new residence, provided an old residence was sold in conjunction with the move. Note that this does not include any GST/HST/PST paid on the new residence.
- Up to $5,000 of interest, property taxes, insurance, and heating and utilities costs on the old residence, subsequent to the time when the individual has moved out and during which reasonable efforts are being made to sell the property. Deduction of this amount is conditional on the home remaining vacant.
- Costs of revising legal documents to reflect a new address, replacing driver's licenses and non-commercial vehicle permits, and connecting and disconnecting utilities.

9-38. Any costs associated with decorating or improving the new residence would not be included in the definition of moving expenses, nor would any loss on the sale of the old residence. Also note that, in general, costs associated with trips to find accommodation at the new location are not included in the definition. The exception to this is meals and lodging near the new residence after it has been acquired or a rental lease has been signed.

### Vehicle And Meal Expenses - Detailed Vs. Simplified Methods

9-39. The CRA offers two alternative methods to calculate the vehicle and meal expenses deductible as moving costs. The detailed method requires receipts and uses actual costs while the simplified method provides a flat rate per meal or kilometer and does not require receipts. The detailed method for vehicle expenses is similar to the calculations required for deductible car costs for employees, a pro rata claim of total vehicle expenses based on the kilometers related to the move.

9-40. The flat rates for the simplified method are provided by the CRA and, for some reason, they are published in a less than timely fashion (e.g., the 2019 rates are not provided until 2020). Although the meal rate of $17 per person per meal has not been changed since 2006, the vehicle expense rate varies by as much as $0.15 per kilometer between the provinces and changes annually. In order to deal this, in all of our problem material, we are going to use a meal rate of $17 per person per meal, and a vehicle expense rate of $0.58 per kilometer (about the average for the provinces). If you wish to find the most recent actual rates, they are available at:

**www.canada.ca/taxes-travel-costs**

### Employer Reimbursements

9-41. As noted in Chapter 3, an employer can reimburse an employee's moving expenses without creating a taxable benefit. It would appear that, for this purpose, the definition of moving expenses is broader than that which applies when an employee is deducting such expenses directly.

> **EXAMPLE** An employer reimburses costs for an employee to visit a new work location in order to find housing and evaluate local schools.
>
> **ANALYSIS** Despite the fact that the employee would not be able to deduct such costs, a reimbursement by the employer does not appear to create a taxable benefit.

9-42. Another example of this situation involves employer reimbursement for a loss on the sale of a residence at the old work location. An employee would not be able to deduct this type of loss. However, ITA 6(20) indicates that only one-half of any reimbursement in excess of $15,000 will be included in the employee's income as a taxable benefit.

> **EXAMPLE** An employer provides a $40,000 reimbursement to an employee for his loss on the sale of his house at the old work location.
>
> **ANALYSIS** The employee would be assessed a taxable benefit of $12,500 [(1/2)($40,000 - $15,000)]. Note that, if the loss is not related to an eligible relocation (i.e., 40 kilometers closer to a new work location), the full amount of any loss reimbursement would be considered to be a taxable benefit under ITA 6(19).

9-43. Employers have also attempted to compensate employees for being required to move to a new work location where housing costs are significantly higher. While there has been a considerable amount of litigation in this area, the issues now seem to be clarified:

> **Lump Sum Payments** In those situations where an employer provides an employee with a lump sum payment to cover the increased cost of equivalent housing at the new work location, the decision in *The Queen v. Phillips* (94 DTC 6177) has established that such an amount will be treated as a taxable benefit to the employee.
>
> **Interest Rate Relief And Other Subsidies** ITA 6(23) makes it clear that an amount paid or assistance provided in respect of an individual's office or employment that is related to the acquisition, financing, or use of a residence, is a taxable employment benefit.

### Tax Planning

9-44. In those cases where the employer does not reimburse 100 percent of an employee's moving expenses, the fact that employers can reimburse certain costs that would not be deductible to the employee can be of some tax planning importance.

9-45. In such partial reimbursement cases, it is to the advantage of the employee to have the employer's reimbursements specifically directed towards those moving costs that the employee would not be able to deduct from Net Income For Tax Purposes. This procedure costs the employer nothing and, at the same time, it permits the employee to maximize the deduction for moving expenses.

**EXAMPLE** An employee has total moving expenses of $22,000. This includes an $8,000 loss on his old residence as a result of the relocation. Other than this loss, the remaining moving costs totaling $14,000 are deductible to the employee. His employer has agreed to pay 60 percent of all moving costs ($13,200 in this case).

**ANALYSIS** Of the $13,200 that will be paid by the employer, $8,000 should be accounted for as a reimbursement for the loss on the old residence. The remaining $5,200 would be included in employment income. As the $8,000 reimbursement is less than the $15,000 limit that can be reimbursed, there will be no taxable benefit. Under this approach, the employee will include the $5,200 allowance in income and will deduct $14,000 in moving costs, a net deduction of $8,800. If the employer had simply paid an allowance of $13,200, the employee would include all of this amount in income and would deduct the same $14,000 of expenses. This net deduction of $800 is $8,000 less than if the employee had been reimbursed for the housing loss.

### Exercise Nine - 1

**Subject:** Moving Expenses

On December 20, 2019, at the request of her employer, Ms. Martinova Chevlak moves from Edmonton to Regina. She has always lived in a rented apartment and will continue to do so in Regina. The total cost of the actual move, including the costs of moving her personal possessions, was $6,400. In addition, she spent $1,300 on a visit to Regina in a search for appropriate accommodation, and $1,200 as a penalty for breaking her lease in Edmonton. During the year, her salary totalled $64,000, of which $2,000 can be allocated to the period after December 20, 2019. Her employer is prepared to pay $6,000 towards the cost of her move. Indicate how Ms. Chevlak can maximize her moving expense deduction. Determine how much of this total can be deducted in 2019 and any carry forward available.

**SOLUTION available in print and online Study Guide.**

**We suggest you work Self Study Problem Nine-1 at this point.**

## Child Care Expenses - ITA 63

### Basic Definitions

9-46. The basic idea here is that a taxpayer is permitted to deduct the costs of caring for children if the costs were incurred in order to allow the taxpayer to produce Taxable Income or receive an education. However, it is the policy of the government to place limits on the amount that can be deducted and, in the process of setting these limits, the rules related to child care costs have become quite complex. As a reflection of this, one of the first Income Tax Folios released was S1-F3-C1, *Child Care Expense Deduction*. In applying the rules, the following terms are relevant:

**Eligible Child** An eligible child is defined in ITA 63(3) to include a child of the taxpayer, his spouse or common-law partner, or a child who is dependent on the taxpayer or his spouse or common-law partner and whose income does not exceed the basic personal credit amount ($12,069 for 2019). In addition, the child must be under 16 years of age at some time during the year or dependent on the taxpayer or his spouse or common-law partner by reason of physical or mental infirmity.

There are different limits for disabled children who are eligible to claim the disability tax credit and those who are not (see following material). To be defined as an eligible child in the aged 16 or over category requires only that they be dependent solely as the result of some form of mental or physical disability. S1-F3-C1 does not provide examples of this level of disability, but states that the degree of the infirmity must be such that it requires the child to be dependent for a considerable period of time.

**Annual Child Care Expense Amount** There are three annual limits. For a dependent child of any age who is eligible for the disability tax credit (e.g., a blind child), the amount is $11,000. For a child under 7 years of age at the end of the year, the amount is $8,000. For a child aged 7 to 16, or a dependent child over 16 who has a mental or physical infirmity, but is not eligible for the disability tax credit, the amount is $5,000.

**Periodic Child Care Expense Amount** This weekly amount is defined as being equal to 2.5 percent (1/40) of the annual child care expense amount applicable to the particular child. Depending on the child, the value per week will be $275 [(2.5%)($11,000)], $200 [(2.5%)($8,000)], or $125 [(2.5%)($5,000)].

**Earned Income** For use in determining deductible child care expenses, earned income is defined as gross employment income (for this purpose, taxable benefits, taxable allowances and stock option benefits are included, but no deductions from employment income are taken into consideration), net business income (for this purpose, business losses are ignored), and amounts of scholarships, training allowances, and research grants that have been included in Net Income For Tax Purposes.

Note that the calculation of earned income for child care expense purposes is different than the earned income calculation used to determine RRSP deduction limits (see Chapter 10).

**Supporting Person** A supporting person is usually the child's parent, or the spouse or common-law partner of the child's parent. However, a supporting person is also an individual who can claim the amount for an eligible dependant or the Canada caregiver amount for the child. Note that, to qualify as a supporting person, the individual must have resided with the person making the child care expense claim at some time during the relevant taxation year or within 60 days of the following year. This means, for example, that if the mother lives with the children, but the supporting father does not, no child care expense is allowed for the father.

9-47. Using the definitions, we can now give attention to the rules applicable to determining the deductible amount of child care expenses.

### *Limits For Lower Income Spouse Or Single Parent*

9-48. There is an implicit assumption in the child care cost legislation that two parent families with a single bread winner should not be able to deduct child care costs. This assumption is implemented through the requirement that, in general, only the spouse (or "supporting person") with the lower income can deduct child care costs. This means that, in most situations, families that have a house parent who is earning no outside income, is not a student, and is capable of taking care of the children, cannot deduct child care costs.

9-49. The amount that can be deducted by the spouse with the lower Net Income For Tax Purposes in a two parent family, or by the single parent when there is no other supporting person, is the least of three amounts:

1. The amount actually paid for child care services, plus limited amounts (see Paragraph 9-53) paid for lodging at boarding schools and overnight camps.
2. The sum of the **Annual Child Care Expense Amounts** for the taxpayer's eligible children ($11,000, $8,000, or $5,000 per child).
3. 2/3 of the taxpayer's **Earned Income** for child care costs purposes.

9-50. Note that there is no requirement that these amounts be spent on specific children. For example, a couple with three healthy children under the age of 7 would have an overall amount under limit 2 of $24,000 [(3)($8,000)]. This $24,000 amount would be the applicable limit even, in the unusual situation where all of the $24,000 was spent on care for one child and nothing was spent for the other children.

9-51. Actual costs include amounts incurred for care for an eligible child in order that the taxpayer may earn employment income, carry on a business, or attend a secondary school (e.g. a high school) or a designated educational institution. In order to be deductible, amounts paid for child care must be supported by proper receipts issued by the payee, including a Social Insurance Number if the payee is an individual. Any amounts paid in the year that are not deductible due to one of the limits, such as earned income, are lost and cannot be carried forward.

9-52. Other constraints indicated in S1-F3-C1, *Child Care Expense Deduction*, are that payments are not deductible if they are made to:

- the father or mother of the eligible child;
- a supporting person of the eligible child;
- a person in respect of whom the taxpayer or a supporting person of the eligible child has deducted a tax credit under section 118 for the year; or
- a person who is under 18 years of age and related to the taxpayer.

### Attendance At Boarding School Or Camp

9-53. A further limitation on actual costs involves situations where one or more children are attending a boarding school or an overnight camp. The federal government does not wish to provide tax assistance for the cost of facilities that provide services that go beyond child care (e.g., computer lessons). As a consequence, when the actual costs involve overnight camps or boarding school fees, the deductible costs are limited to the Periodic Child Care Expense Amount ($275, $200 or $125 per week, per child). Amounts paid to the camp or boarding school in excess of these amounts would not be deductible.

9-54. Note that this weekly limit does not apply to fees paid to day camps or sports camps that do not include overnight stays. Even when there are overnight stays, for fees to day camps and day sports schools to be eligible for a child care deduction, the primary goal of the camp must be to care for the children as opposed to providing sports education.

### When Deductible By Higher Income Spouse

9-55. In the preceding material, we noted the general rule that child care costs are to be deducted by the lower income spouse. There are however, a number of exceptions to this general rule. Specifically, the higher income spouse is allowed to make the deduction if:

- the lower income spouse is a student in attendance at a secondary school or a designated educational institution and enrolled in a program of the institution or school that is not less than 3 consecutive weeks duration and provides that each student in the program spend not less than:
  - 10 hours per week on courses or work in the program (i.e., full time attendance); or
  - 12 hours per month on courses or work in the program (i.e., part time attendance);
- the lower income spouse is infirm and incapable of caring for the children for at least 2 weeks because of confinement to a bed, wheelchair, hospital, or asylum (this condition requires a written certificate from a medical doctor supporting the fact that the individual is incapable of caring for children);

- the lower income spouse is likely to be incapable of caring for children for a long and continuous period because of a mental or physical infirmity (this condition requires a written certificate from a medical doctor supporting the fact that the individual is incapable of caring for children);
- the lower income spouse is a person confined to a prison or similar institution throughout a period of not less than 2 weeks in the year; or
- the spouses are separated for more than 90 days beginning in the year.

9-56. In situations where the higher income spouse is making the deduction, the amount of the deduction would be subject to the same limitations that are applicable when the deduction is being made by the lower income spouse. However, the higher income spouse has a further limitation. This additional limit is calculated by multiplying the sum of the Periodic Child Care Expense Amounts for all eligible children, by the number of weeks that the lower income spouse is infirm, in prison, separated from the higher income spouse, or attending an educational institution on a full-time basis. If the attendance is part-time, the sum of the Periodic Amounts is multiplied by the number of months of part-time attendance, not weeks.

## *Example*

9-57. The following example will help clarify the general rules for child care costs.

**EXAMPLE** Jack and Joanna Morris have three children, Bruce, Bobby, and Betty. At the end of 2019, Bruce is aged 18 and, while he is physically disabled, his disability is not severe enough that he qualifies for the disability tax credit. With respect to their other children, Bobby is aged 6 and Betty is aged 5 at the end of the year. Jack has 2019 earned income of $45,000, while Joanna has 2019 earned income of $63,000.

The couple has full time help to care for their children during 49 weeks of the year. The cost of this help is $210 per week ($10,290 for the year). During July, the children are sent to summer camp for three weeks. The camp fees total $3,500 for this period for all three children.

As the result of a substance abuse conviction, Jack spends seven weeks in November and December in prison.

**ANALYSIS** The deductible child care costs would be the least of the following amounts:

| | Joanna | Jack |
|---|---|---|
| Actual child care costs plus maximum deductible camp fees {$10,290 + [(2)($200)(3 weeks) + (1)($125)(3 weeks)]} | $11,865 | $11,865 |
| Annual Child Care Expense Amount [(2)($8,000) + (1)($5,000)] | 21,000 | 21,000 |
| 2/3 of earned income | 42,000 | 30,000 |
| Periodic Child Care Expense Amounts [(2)($200)(7 weeks) + (1)($125)(7 weeks)] | 3,675 | N/A |

While Joanna is the higher income spouse, she can deduct child care costs for the seven weeks that Jack is in prison. Her maximum deduction is $3,675. Jack's limit is $11,865. This must be reduced by the $3,675 deducted by Joanna to $8,190 ($11,865 - $3,675).

Note that, while Bruce, at age 18, is an eligible child because of his disability, the fact that the disability is not severe enough to qualify Bruce for the disability tax credit means that his annual limit is $5,000 rather than $11,000, and that the periodic limit for Joanna and for the camp fees is $125 rather than $275.

## Exercise Nine - 2

**Subject:** Child Care Expenses

Mr. and Mrs. Sampras have three children. The ages of the children are 4, 9, and 14, and they are all in good mental and physical health. During the current year, Mr. Sampras has net employment income of $14,000, after the deduction of employment expenses of $5,500. Mrs. Sampras has net business income during this period of $54,000, after deducting business expenses of $21,000. The child care costs for the current year, all properly documented for tax purposes, are $10,500. Determine the maximum deduction for child care costs and indicate who should claim them.

**SOLUTION available in print and online Study Guide.**

**We suggest you work Self Study Problems Nine-2 and Nine-3 at this point.**

## Disability Supports Deduction - ITA 64

### *Eligibility And Coverage*

9-58. In order to assist disabled individuals who work or go to school, ITA 64 provides a disability supports deduction that is available to disabled individuals who are:

- performing duties of an office or employment,
- carrying on a business, either alone or as a partner actively engaged in the business,
- attending a designated educational institution or a secondary school, or
- carrying on research in respect of which the individual received a grant.

9-59. The deduction is available for an extensive list of costs that can be associated with a disabled person working or going to school. The costs must be paid for by the disabled individual and eligible costs include:

- sign-language interpretation services, a teletypewriter or similar device;
- a Braille printer;
- an optical scanner, an electronic speech synthesizer;
- note-taking services, voice recognition software, tutoring services; and
- talking textbooks.

9-60. The availability of this deduction is not limited to individuals who qualify for the disability tax credit. As an example, if an individual has a hearing impairment that requires sign language assistance, the costs of such services are deductible, without regard to whether the individual is eligible for the disability tax credit. In most cases, a medical practitioner must provide a prescription, or certify that there is a need for incurring the specific type of cost.

### *Limits On The Amount Deducted*

9-61. The amount of qualifying costs that can be deducted under ITA 64 is limited to the lesser of:

- An amount determined by the formula:

**A - B**, where

**A** is equal to the qualifying disability support costs and

**B** is equal to any reimbursement (such as payments from medical insurance) of amounts included in **A** that were not included in income.

- The total of:
  1. Gross employment income, net business income, and scholarships and research grants to the extent they are included in Net Income For Tax Purposes.
  2. Where the individual is in attendance at a designated educational institution or secondary school, the least of:
     - $15,000;
     - $375 times the number of weeks of school attendance at a designated educational institution or secondary school; and
     - the amount by which the individual's Net Income For Tax Purposes exceeds the amounts of income included in item 1.

### Disability Supports Deduction Vs. Medical Expenses Tax Credit

9-62. Since many of the costs that can be deducted under the disability supports deduction could also be claimed for the medical expenses tax credit, it may be difficult for a disabled person to determine the more advantageous way to claim the expenditures. The legislation does not allow amounts that are deducted under the disability supports deduction to be included in the base for the medical expense tax credit.

9-63. In choosing between the alternative uses of these costs, the following factors should be taken into consideration:

- The base for the medical expense tax credit is reduced by 3 percent of the taxpayer's Net Income For Tax Purposes.
- Tax credits are calculated using the lowest tax bracket. If the taxpayer's income places them in a higher tax bracket, the deduction of costs under the disability supports program will provide a larger reduction in taxes.
- If the taxpayer has only limited amounts of Taxable Income, the ability to use the refundable medical expense tax credit may be more beneficial.
- The deduction is only available to the disabled person on costs that have been paid for personally by the disabled person. If a spouse or supporting person has paid the costs, the spouse or supporting person could claim the medical expense credit with respect to these costs, but could not claim the disability supports deduction.

9-64. It is interesting to note that the treatment given to these costs is very different from the treatment given to home accessibility costs which was discussed in Chapter 4. Costs qualifying for the home accessibility credit can also be eligible for inclusion in the base for the medical expense tax credit. With respect to these latter costs, the taxpayer is allowed to double count, including the qualifying amounts in the base of both the home accessibility credit and the medical expense credit. This is in contrast to the situation here where the taxpayer must choose to either deduct disability support costs, or include the costs in the base for the medical expenses credit. It is difficult to understand the conceptual basis for this distinction.

### Complications Related To Attendant Care Costs

9-65. If an individual qualifies for the ITA 118.3 disability tax credit, he can claim attendant care costs as a medical expense. As discussed in Chapter 4, if the medical expense claim is for full time attendant care (defined as more than $10,000 per year), the individual loses the ability to claim the disability tax credit. We would note that, if attendant care costs are over $10,000, it may be beneficial to limit the medical expense credit claim to $10,000 in order to stay within the definition of "part time". This would prevent the taxpayer from losing his claim to the disability tax credit.

9-66. Form T929 indicates that only individuals who qualify for the disability tax credit can claim amounts paid for part time attendant care as a disability supports deduction. However, provided the need for such care is certified by a medical practitioner, full time care can be

claimed by individuals who do not qualify for the disability tax credit. This results in a very complex situation with respect to these costs. We have tried to simplify the possibilities in the following general summary:

- If an individual qualifies for the disability tax credit, he can claim attendant care costs as either an addition to the base for the medical expense tax credit, or as a disability supports deduction within the limits of ITA 64. If the disabled individual had sufficient income to move them out of the minimum 15 percent federal tax bracket, the latter choice would provide the larger benefit.
- If an individual qualifies for the disability tax credit and has attendant care costs in excess of $10,000, he is faced with a choice. He can add the full amount of the attendant care costs to the medical expenses tax credit base. However, this claim will result in the loss of the disability tax credit. Alternatively, he can claim these costs as a disability supports deduction, provided a medical practitioner will certify the need for such care. This will usually be preferable as he will continue to qualify for the disability tax credit.
- If an individual is disabled, but does not qualify for the disability tax credit, he can deduct full time attendant care costs under ITA 64, provided a medical practitioner certifies the need for full time attendant care. However, this individual cannot deduct the costs of part time attendant care.

### Exercise Nine - 3

**Subject:** Disability Supports Deduction

Jose Morph has visual, speech, and hearing disabilities. However, they are not severe enough to allow him to qualify for the disability tax credit. During 2019, he worked on a full time basis as a programmer for a large public company and his employment income totaled $78,000.

His need for full time attendant care has been certified by a medical practitioner and, during 2019, such care cost Jose $23,000. Other deductible costs required to support his ability to work as a disabled person totaled $18,000, all of which were certified by a medical practitioner. His medical insurance reimbursed him for $5,000 of these expenses. Jose will not include any of these costs in his base for the medical expenses tax credit. Calculate Jose's disability supports deduction for 2019.

**SOLUTION available in print and online Study Guide.**

# Related Inclusions And Deductions

## Introduction

9-67. At the beginning of this Chapter, we noted that there are several Subdivision e deductions that are directly related to an item that is included in Subdivision d. These items will be dealt with in this Section.

## Employment Insurance Benefits - ITA 56(1)(a)(iv) And 60(n)

9-68. ITA 56(1)(a)(iv) requires that Employment Insurance (EI) benefits received be included in income, even if they are subsequently repaid. Repayment of these benefits can be required if an individual has Net Income in excess of a specified level. If EI benefits must be repaid, the repayment can be deducted under ITA 60(n).

# Pension Income Splitting - ITA 56(1)(a.2) And 60(c)

## General Rules

9-69. As noted in the Chapter 1 discussion of tax planning, income splitting is one of the most effective techniques that can be used by taxpayers. Here in this Chapter, we will cover pension income splitting. While this can offer significant tax savings, it is only available to individuals who have certain types of pension income. A possible vehicle for limited income splitting among family members is the Tax Free Savings Account (TFSA). It is discussed later in this chapter. Spousal Registered Retirement Savings Plans, which require some long term planning to be effective for income splitting, will be discussed in Chapter 10.

9-70. The basic provision for the pension income split is found in ITA 60.03. This Section allows a pensioner, defined as any resident Canadian who receives eligible pension income, to file a joint election with a spouse or common-law partner to reallocate up to 50 percent of his pension income to a pension transferee (i.e., the spouse or common-law partner).

9-71. When the election is made, the pension transferee includes the elected amount in income under ITA 56(1)(a.2) and the same amount is deducted by the pensioner under ITA 60(c). The election requires the filing of a prescribed form T1032. The pensioner can choose to split any amount, from nothing up to a maximum of 50 percent of eligible pension income. The percentage can vary year to year at the discretion of the pensioner.

9-72. The types of pension income that are eligible for splitting are the same as those that are eligible for the pension income tax credit. You may recall from Chapter 4 that there are different rules for taxpayers who are under 65 years of age and those 65 and over. In general, most types of pension income other than OAS and CPP can be split for those 65 and over.

9-73. Note, however, that while lump sum withdrawals from Registered Retirement Income Funds are eligible for splitting, lump sum payments from Registered Pension Plans or lump sum withdrawals from Registered Retirement Savings Plans do not qualify for this provision. Also note that while the age of the transferor determines the types of pension income that can be split, the age of the transferee has no influence on this matter.

9-74. Another point here relates to withholding. Taxes are withheld at the source from most pension amounts that are paid to an individual. ITA 153(2) indicates that, if a portion of this pension income is allocated to a spouse or common-law partner, a proportionate share of the total withholding is deemed to be on behalf of that spouse or common-law partner. This means that this proportionate share of tax withheld will be transferred to the tax return of the spouse or common-law partner to reduce their Tax Payable or increase the amount of their refund.

## Complications

9-75. In some cases, the desirability of pension income splitting is fairly obvious. For example, an individual in the highest tax bracket can transfer a significant amount of income to a spouse who has no income, resulting in a large amount of income being taxed at the lowest rate. In addition, the transfer can create a pension income tax credit for the transferee.

9-76. There are, however, offsetting factors. These include the loss of the spousal tax credit, the loss of the transferee's age credit, or a decrease in the medical expenses credit. There is also the possibility that the transfer could create or increase a transferee's OAS clawback.

9-77. Given these complications, it is not possible to have a general rule related to the use of pension income splitting. In cases where one spouse has no pension income, it will generally be desirable to transfer enough pension income to create a pension income tax credit. However, transfer of additional amounts involves a large number of considerations. Fortunately, tax preparation software can assist in determining an optimum solution.

## Exercise Nine - 4

**Subject:** Pension Income Splitting

Joanna Sparks lives with her husband of many years, John Sparks. They are both 67 years of age. During 2019, Joanna received $7,400 in OAS payments. She also receives $85,000 of pension income from a plan that was sponsored by her former employer. She has not, at this point in time, applied for CPP. John's only source of 2019 income is $7,400 in OAS payments. Neither Joanna nor John has any tax credits other than the basic personal credit, age credit, and pension income credit.

Joanna has asked you to indicate the savings in federal tax that would result from making optimum use of pension income splitting for the 2019 taxation year.

**SOLUTION available in print and online Study Guide.**

**We suggest you work Self Study Problems Nine-4 and Nine-5 at this point.**

# Spousal And Child Support - ITA 56(1)(b) And 60(b)

## *Definitions*

9-78. ITA 56.1(4) provides definitions for both support and child support:

**Support Amount** means an amount payable or receivable as an allowance on a periodic basis for the maintenance of the recipient, children of the recipient or both the recipient and children of the recipient, if the recipient has discretion as to the use of the amount, and

(a) the recipient is the spouse or common-law partner or former spouse or common-law partner of the payer, the recipient and payer are living separate and apart because of the breakdown of their marriage or common-law partnership, and the amount is receivable under an order of a competent tribunal or under a written agreement; or

(b) the payer is a legal parent of a child of the recipient and the amount is receivable under an order made by a competent tribunal in accordance with the laws of a province.

**Child Support Amount** means any support amount that is not identified in the agreement or order under which it is receivable as being solely for the support of a recipient who is a spouse or common-law partner or former spouse or common-law partner of the payer or who is a parent of a child of whom the payer is a legal parent.

9-79. When read together, these two definitions provide, in effect, a definition of spousal support. For an amount to be treated as spousal support, it must be specifically designated as being solely for the support of a recipient who is a spouse or common-law partner, a recipient who is a former spouse or common-law partner, or a recipient who is the parent of a child of whom the payer is a legal parent.

## *General Tax Treatment*

9-80. Under the currently applicable rules, only those payments that are clearly designated as spousal support are deductible by the payer under ITA 60(b). Such payments would then be taxable to the recipient under ITA 56(1)(b). As noted in the section which follows, there are other conditions that must be met to qualify the payments for deduction and inclusion.

9-81. Child support, which would include all support amounts that are not clearly designated as spousal support, cannot be deducted by the payer. Consistent with this, the amounts paid are not taxed in the hands of the recipient.

## Conditions For Deduction And Inclusion

9-82. As described in S1-F3-C3, *Support Payments*, an amount is considered a support payment if:

- it is payable or receivable as an allowance on a periodic basis;
- it is paid for the maintenance of the recipient, the children of the recipient, or both;
- the recipient has discretion as to the use of the amount; and
- where the recipient of the amount is the spouse or common-law partner or former spouse or common-law partner of the payer, the parties are living separate and apart because of a breakdown of their relationship and the amount is receivable under an order of a competent tribunal or under a written agreement; or
- where the recipient is the parent of a child of whom the payer is a legal parent, the amount is receivable under an order of a competent tribunal in accordance with the laws of a province or territory.

9-83. If an amount is considered to be a support payment, the amount that is deductible to the payor and taxable to the recipient is defined in ITA 60(b) as the total of such support payments, less any amounts that are considered to be child support. Note that, based on the definition in ITA 56.1(4), any amounts that are not clearly designated as spousal support, are considered to be child support.

9-84. While payments prior to the date of a court decree cannot technically be made pursuant to that decree, ITA 56.1(3) and ITA 60.1(3) deem that payments made in the year of the decree or the preceding year will be considered paid pursuant to the decree, provided that the order or agreement specifies that they are to be so considered.

9-85. Problems often arise with respect to the requirement that payments be made on a periodic basis. Clearly, a single lump sum payment does not qualify, nor does a payment that releases the payer from future obligations. Payments that are in excess of amounts required to maintain the spouse and/or children in the manner to which they were accustomed are also likely to be disallowed. Other factors that should be considered are the interval at which the payments are made and whether the payments are for an indefinite period, or a fixed term.

9-86. Under some circumstances, a person who receives support payments and includes the amount received in income may be required to repay some portion of these amounts. In these circumstances, the person making the repayment is allowed to deduct the amount repaid [ITA 60(c.2)]. As you would expect, the recipient is required to include a corresponding amount in income [ITA 56(1)(c.2)].

## Additional Considerations

9-87. There are a number of additional considerations related to the tax treatment of support payments:

- In situations where a required payment includes both child support and spousal support, a problem arises when less than the required amount is remitted. In such cases, the question becomes whether the payments that were made were for child support or, alternatively for spousal support. The required solution in ITA 56(1)(b) and 60(b) is that only payments in excess of the required child support will be deductible/taxable spousal support. For example, consider an individual required to pay $4,000 in child support and $12,000 in spousal support. If a total of $7,000 is paid during the year, only $3,000 of that amount will be deductible/taxable as spousal support.

- In general, payments to third parties that are clearly for the benefit of the spouse are deductible to the payer and taxable to the spouse.

- Deductible support payments reduce the payer's earned income for RRSP purposes. Correspondingly, taxable support payments increase the recipient's earned income for RRSP purposes (see Chapter 10).

- The recipient of child support payments will continue to be eligible for the credit for an eligible dependant (see Chapter 4).
- ITA 118(5) prevents an individual from taking a tax credit for a spouse or eligible dependant and, at the same time, deducting support payments to that spouse or child.
- While it is not part of the legislation, the Government of Canada has published an extensive, province by province list of guidelines for child support. These guidelines are dependent on the number of children involved and the income of the payer.

## Exercise Nine - 5

**Subject:** Support Payments

On June 15, 2019, Sandra and Jerry Groom sign a separation agreement that calls for Sandra to pay Jerry $1,500 per month in child support (Jerry will have custody of their five children) and $2,500 per month in spousal support beginning July 1. During 2019, Sandra pays support for only three months. How will the total support paid of $12,000 be dealt with in Sandra and Jerry's 2019 tax returns?

**SOLUTION available in print and online Study Guide.**

## Annuity Payments Received - ITA 56(1)(d) And 60(a)

### *Annuities And Their Uses*

9-88. ITA 248(1) defines an annuity as an amount payable on a periodic basis, without regard to whether it is payable at intervals longer or shorter than a year. As the term is usually applied, it refers to the investment contracts that are usually sold by insurance companies. The two basic forms of these contracts involve either payments for a specified period (e.g., annual payments for a period of 10 years), or payments for the life of the annuitant (e.g., annual payments until the recipient of the payment dies).

9-89. These contracts can also take various types of hybrid forms. For example, a common arrangement would be a life annuity, with payments guaranteed for a minimum of 10 years. In this case, if the annuitant dies prior to the end of 10 years, payments will continue to be made to the deceased's estate until the end of the specified guarantee period.

9-90. Annuities are widely used in retirement and estate planning because they provide a guaranteed stream of income that is virtually risk free. Also important is the fact that, in the case of life annuities, the annuitant does not have to be concerned with outliving the income stream. As you would expect, these desirable features are offset by low rates of return.

9-91. The taxation of annuity payments depends on the manner in which the investment contract was acquired:

**Acquisition Within A Tax Deferred Plan** Annuities are often purchased by the administrator of such tax deferred plans as Registered Pension Plans (RPPs), Registered Retirement Savings Plans (RRSPs), Registered Retirement Income Funds (RRIFs), and Deferred Profit Sharing Plans (DPSPs). The goal here is to provide the beneficiary of the plan with a fixed and guaranteed stream of income, usually at the time of their retirement. Because contributions to these plans are deductible and earnings on assets held within the plans accumulate on a tax free basis, all payments out of these plans are subject to tax. This means that, the full amount of payments made from annuities that have been purchased within these plans must be included in the recipient's Net Income For Tax Purposes.

**Acquisition Outside Tax Deferred Plan** Individuals also purchase annuities outside of tax deferred plans. The potential problem in this case can be illustrated by a simple example:

**EXAMPLE** Pierre Brissette uses funds from his savings account, (i.e., after tax funds), to purchases a 5 year ordinary annuity with payments of $2,309 at the end of each year. The cost of the annuity is $10,000, providing him with an effective yield of 5 percent.

**ANALYSIS** The total payments on this annuity would be $11,545. This total is made up of $1,545 of earnings, plus $10,000 which represents a return of Mr. Brissette's capital. It would not be equitable to require Mr. Brissette to include the full amount of the annuity payments in his Net Income For Tax Purposes. Clearly, some type of provision is required to recognize the return of capital components of the annuity payments that he has received.

### Capital Element Of An Annuity

9-92. You will recall from Paragraph 9-20 of this Chapter, that payments from registered plans are included under specific provisions of subdivision d [e.g., payments from RRSPs are included under ITA 56(1)(h)].

9-93. In order to distinguish these fully taxable annuity payments from payments made by annuities acquired outside of tax deferred plans, ITA 56(1)(d) requires the inclusion in income of annuity payments that are not "otherwise included in income". As payments from RPPs, RRSPs, RRIFs, and DPSPs, are "otherwise included" under other provisions of the *Income Tax Act*, this means that only annuities purchased with after tax funds would be included here.

9-94. For those annuity payments that are included under ITA 56(1)(d), ITA 60(a) allows a deduction that is designed to reflect the return of capital element that is included in these payments. The capital element that is to be deducted is calculated by multiplying the annuity payment that was included in income for the year by a ratio. As presented in ITR 300, the formula for calculating the capital element of a fixed term annuity payment is as follows:

$$\text{Deduction} = \left[\frac{\text{Capital Outlay To Buy The Annuity}}{\text{Total Payments To Be Received Under The Contract}}\right]\text{[Annuity Payment]}$$

9-95. To illustrate this procedure, refer to the example in Paragraph 9-91. Since this annuity had been purchased with $10,000 in after tax funds, the entire annual payment of $2,309 would be included in income under ITA 56(1)(d). However, this would be offset by a deduction under ITA 60(a) that is calculated as follows:

$$\left[\frac{\$10{,}000}{\$11{,}545}\right][\$2{,}309] = \$2{,}000 \text{ Deduction}$$

9-96. Note that this treatment would apply to situations where an individual has made a lump-sum withdrawal from a tax deferred plan and used the funds to acquire an annuity. For example, if an individual withdrew $100,000 from his RRSP, this amount would be subject to tax at the time of withdrawal. This means that payments from this annuity would be included in his income under ITA 56(1)(d) rather than 56(1)(h) and, as a consequence, would be eligible for the ITA 60(a) deduction.

## Exercise Nine - 6

**Subject:** Annuity Payments

On January 1 of the current year, Barry Hollock uses $55,000 of his savings to acquire a fixed term annuity. The term of the annuity is 4 years, the annual payments are $15,873, the payments are received on December 31 of each year, and the rate inherent in the annuity is 6 percent. What is the effect of the $15,873 annual payment on Mr. Hollock's Net Income For Tax Purposes?

**SOLUTION available in print and online Study Guide.**

# Registered Savings Plans

## Introduction

9-97. Registered savings plans allow individuals to make contributions to a trust that is registered with the CRA. The trustees of the plan are required to provide information returns with respect to contributions to, and withdrawals from, these plans.

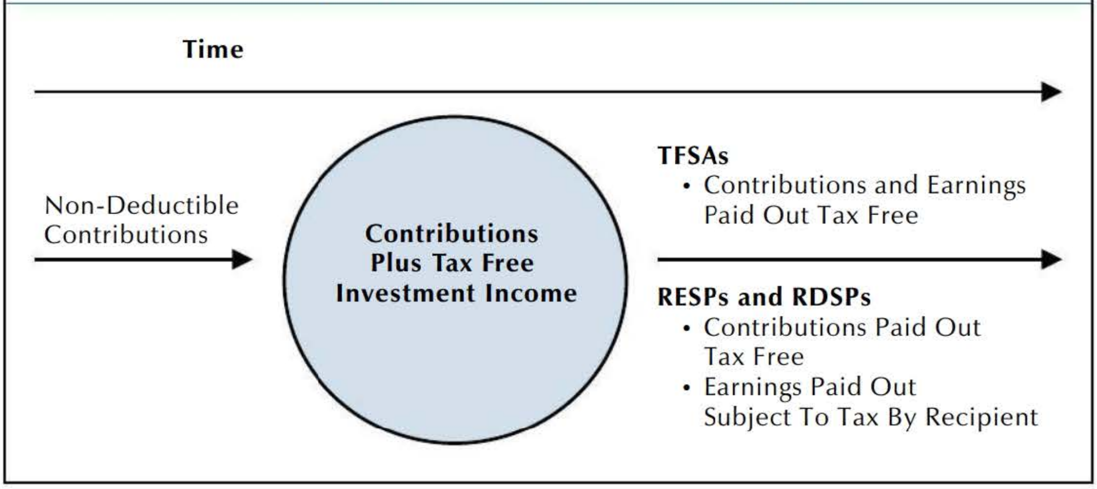
9-98. As indicated in Paragraph 9-6, in this Chapter we will provide detailed coverage of two of these plans, Registered Education Savings Plans (RESPs), and Tax Free Savings Accounts (TFSAs). We will also provide a brief description in this Chapter of Registered Disability Savings Plans (RDSPs). Other registered plans will be covered in Chapter 10.

9-99. Contributions to the plans that are being considered in this Chapter are not deductible in determining the taxpayer's Net Income For Tax Purposes. However, they do have significant tax advantages.

> **Tax Deferral** Once contributions have been made, they will be invested in various types of income producing assets. There will be no taxation of this income, including compounding amounts, as long as the assets remain in the plan. This provides for significant tax deferral.
>
> **Tax Reduction (RESPs And RDSPs)** Contributions to these plans will typically be made by a parent or grandparent who has income that will be taxed at various rates, in most cases at rates higher than the minimum rate. While earnings distributions from RESPs and RDSPs are subject to tax, they will be paid to either a student or a disabled person.
>
> In many cases, such individuals will not have sufficient income to use their available tax credits, resulting in a situation where some amounts can be distributed without attracting additional taxation. Even if this is not the case, such individuals are likely to be in a lower tax bracket than the individual who made the contributions, resulting in a tax reduction that may be significant.

9-100. The basic operation of TFSAs, RESPs, and RDSPs is depicted in Figure 9-1. As shown in that Figure, the contributions to these plans are non-deductible to the taxpayer. This is in contrast to both RPPs and RRSPs where the contributions can be deducted at the time they are made (see Chapter 10).

**Figure 9 - 1**
**TFSAs, RESPs And RDSPs - The Basic System**



## Tax Free Savings Accounts (TFSAs)

### General Procedures

9-101. The general procedures for Tax Free Savings Accounts (TFSAs) are as follows:

**Eligibility** Any resident individual over 17 years of age can establish a TFSA.

**Contribution Room** When TFSAs were introduced in 2009, the maximum annual contribution to the plan was $5,000. This was increased to $5,500 in 2013, with a further increase to $10,000 for 2015. This was for one year only as the maximum annual contribution was returned to $5,500 for 2016, 2017, and 2018. For 2019, it was increased to $6,000. The contribution room accumulates each year the individual is over 17, without regard to whether the individual has established a TFSA or filed a tax return. For an individual who was over 17 years of age in 2009, as of 2019, total TFSA contribution room has accumulated to $63,500 (4@$5,000 + 2@$5,500 + 1@ $10,000 + 3@$5,500 + 1@$6,000).

Unused amounts of this contribution room can be carried forward indefinitely and any withdrawals (consisting of contributions and earnings) are added back to the total contribution room. It is important to note that this addition to contribution room does not occur until the year following the withdrawal. Ignoring this timing lag can result in an excess contribution which will be subject to a penalty. To assist taxpayers, unused TFSA contribution room information can be accessed by using the CRA "My Account" online service. (See Chapter 2.)

Unlike RRSPs, the contributions are not deductible. Contributions in excess of available contribution room will be subject to a tax of 1 percent per month. Interest on money borrowed to make contributions is not deductible. This rule reflects the general principle that interest can only be deducted when the purpose of the borrowing is to produce income from business or property.

**Qualified Investments** The *Act* is flexible with respect to the types of investments that can be included in a TFSA. ITR Part XLIX provides a detailed listing of the specific investment categories and includes publicly traded shares, mutual fund units, bonds, mortgages, warrants, and rights. The only significant restrictions relate to investments in the shares of private companies and direct investments in real estate. There is no limit on foreign content. For a more complete discussion of this subject see IT Folio S3-F10-C1, *Qualified Investments - RRSPs, RESPs, RRIFs, RDSPs, and TFSAs*, and IT Folio S3-F10-C2, *Prohibited Investments - RRSPs, RRIFs, and TFSAs*.

**Investment Income** As is the case with other registered savings plans, amounts earned on assets held in the plan are not subject to tax while they remain within the plan. However, unlike other registered savings plans, there is no tax on these earnings when they are withdrawn. As their name implies, TFSAs allow investors to receive investment income on a tax free basis. Any losses on the sale of investments in the TFSA have no tax benefit, they simply reduce the TFSA funds available.

**Income Attribution Rules** As will be discussed in the final section of this Chapter, when an individual gives assets to a spouse, income on those assets is usually attributed back to that individual. Another attractive feature of TFSAs is that amounts earned in these accounts are not subject to the income attribution rules.

**Death Of A Taxpayer** If an individual's spouse or common-law partner is designated as a successor holder, the individual's TFSA can be transferred into the hands of this beneficiary as an ongoing TFSA. It can either be maintained by the individual as a separate TFSA or, alternatively, rolled over into their TFSA without being treated as a contribution. Income on the assets contained in the bequeathed TFSA will continue to accumulate on a tax free basis.

If the decedent's TFSA is transferred to any other beneficiary, that individual can withdraw the funds in the plan at the time of the transferor's death without tax

consequences. However, any amounts received in excess of the fair market value of the assets in the plan at the time of the transferor's death will be subject to tax.

## Registered Education Savings Plans (RESPs)

### *Contributions*

9-102. The contribution rules for Registered Education Savings Plans (RESPs) are found in ITA 146.1. As previously noted, like contributions to a TFSA, contributions to an RESP do not provide a deduction for the taxpayer, but earnings in the plan accrue on a tax free basis.

9-103. As is discussed more completely in Chapter 10, over extended periods of time, there is a very large benefit associated with this tax free accumulation of earnings. Note, however, that in the case of RESPs, this tax free accumulation is limited to 35 years after the plan is established (40 years for plans with a single beneficiary who is eligible for the disability tax credit). At the end of that period, the plan is automatically deregistered.

9-104. An individual, usually a parent or grandparent becomes a subscriber or a joint subscriber of an RESP by signing a contract with an RESP promoter. Total contributions are limited to $50,000 for each beneficiary with no annual limit on contributions. Although there is complete flexibility with respect to the timing, some consideration should be given to the CESG limits (see Paragraph 9-106).

9-105. There is a penalty for excess contributions. If, at the end of any month, the contributions for a particular beneficiary exceed the total limit of $50,000, the subscribers to the plan are subject to a 1 percent per month tax on the excess. Note that these limits apply for each beneficiary. If several individuals are contributing to different plans with the same beneficiary (e.g., Joan's father and her grandmother are both contributing to a plan on her behalf), the sum of their contributions to Joan's plans cannot exceed the $50,000 limit. Any tax assessed on excess contributions must be shared on a pro rata basis by the subscriber(s).

### *Canada Education Savings Grants (CESGs)*

9-106. Under the Canada Education Savings Grant (CESG) program, the federal government will make additional contributions to an RESP to supplement those being made by the subscriber(s). The CESG has both a basic and "additional" component.

9-107. The amount of grant eligible contributions is a balance that accumulates at the rate of $2,500 per year, beginning in the year a child is born. The basic CESG is equal to 20 percent of the current year contributions for a beneficiary up to a maximum of $500 [(20%)($2,500)] per beneficiary. If there is unused contribution room from previous years, up to $1,000 in CESG is available in the current year. The lifetime CESG maximum is $7,200.

9-108. In order to assist low income families, an additional CESG of 10 or 20 percent of the first $500 of contributions in a year for a beneficiary is available. The amount of the additional CESG depends on the net family income for the year. On the first $500 in contributions for 2019, the basic and additional CESG is calculated as follows:

- at 40% (20% + 20%) if 2019 family income is $47,630 or less (maximum of $200),
- at 30% (20% + 10%) if 2019 family income is between $47,630 and $95,259 (maximum of $150), and
- at 20% (20% + 0%) if 2019 family income is greater than $95,259 (maximum of $100).

9-109. As noted, regardless of family income, for each beneficiary, contributions between $500 and $2,500 in a year earn a grant equal to 20 percent of the contributions.

> **EXAMPLE** Tom is born in February, 2018. Tom's father makes an RESP contribution of $1,300 for Tom in 2018 and $1,300 in 2019. In November of 2019, Tom's grandmother makes a $3,000 contribution to another RESP for Tom.
>
> **ANALYSIS** Tom's 2019 contribution room for balances eligible for CESGs is $3,700 [(2)($2,500) - $1,300]. As the combined contributions of the father and grandmother total $4,300, $600 of the total contributions will not be eligible for CESGs.

Depending on the net family income of Tom's father, the CESG for 2019 ranges from \$740 [(20%)(\$3,700)] to \$840 [(40%)(\$500) + (20%)(\$3,700 - \$500)].

It is important to note that the \$600 excess contribution does not carry forward and become eligible for CESGs in the following year when more contribution room accrues to Tom. If it is expected that annual contributions to Tom's RESP will be less than \$2,500 in the future, this would suggest that Tom's father should limit his 2019 contribution to \$700 and defer the extra \$600 to the following year. In that year, it would eligible for a grant. Also note that if there is a large carry forward of grant eligible contribution room, the CESG will be limited to a maximum of \$1,000 for a year, (\$500 current plus \$500 carry forward) regardless of the size of the contribution.

For those subscribers who have substantial funds to invest, there is the option of contributing a large initial sum to take advantage of tax free compounding. Whether this would be more advantageous than contributing less, more often, in order to take full advantage of the CESG requires the consideration of a number of factors. That analysis would go beyond the scope of this text.

9-110. CESGs will not be paid for RESP beneficiaries for the year in which they turn 18 years of age, or in any subsequent year. In addition, CESG payments are intended to encourage long-term planning for a child's education. Because of this, in a year in which the beneficiary is between the age of 15 and the age of 17, CESG payments will be made only when:

- a minimum of \$2,000 of RESP contributions was made in respect of the beneficiary by December 31 of the calendar year in which the beneficiary attains 15 years of age; or
- a minimum of \$100 in annual RESP contributions was made in respect of the beneficiary in any four years before the calendar year in which the beneficiary attains 15 years of age.

## Exercise Nine - 7

**Subject:** Canada Education Savings Grants

Jeanine was born in 2018. During 2018, her father establishes a RESP for her and contributes \$500 to the plan, while Jeanine's grandfather contributes an additional \$1,200. During 2019, her father contributes \$1,500 and her grandfather adds a further \$2,400. Jeanine's family has never had family income of more than \$40,000. Determine the amount of the CESGs that would be added to Jeanine's RESP in 2018 and 2019.

**SOLUTION available in print and online Study Guide.**

### Canada Learning Bonds (CLBs)

9-111. A further enhancement to the RESP system, Canada Learning Bonds (CLBs), are like the CESGs in that the government makes contributions to a child's RESP. However, unlike the CESGs, the CLB contributions are not based on contributions made to the RESP by others.

9-112. The CLB provisions apply to children born after 2003 and who have an RESP established in their names. Such children are eligible for a CLB contribution to their RESP in each year that their family is eligible for the child National Child Benefit Supplement (this supplement is an income test benefit that is added to the Canada Child Tax Benefit). Potential eligibility begins in the year the child is born and ends in the year that the child turns 15 years of age.

9-113. The CLB contributions to individual RESPs are as follows:

- In the first year that the child is eligible for a CLB contribution, an amount of \$500 will be provided. In addition, a one-time additional amount of \$25 will be added in order to help defray the costs of establishing the RESP.

- In each subsequent year of eligibility, a CLB contribution of $100 will be made. This continues until the year in which the child turns 15 years of age.

9-114. The child's eligibility will vary with the income of his or her family. In some families, the National Child Benefit supplement will be available every year and, correspondingly, the CLB contributions will be made each year. In situations such as this, the maximum total contribution would be $2,025 {$500 + $25 + [(15)($100)]}. In other cases, eligibility may be present in some years and not present in other years. In such cases, the contributions will total less than $2,025.

9-115. For families who qualify for the CLB contributions, the establishment of an RESP for each child is clearly a desirable course of action. A potential problem with the CLB program is that families in the income brackets that qualify for this benefit may not be aware of the program or have access to the kind of assistance required to establish an RESP.

## Types Of Plans

9-116. RESP legislation provides for "family plans" in which each of the beneficiaries is related to the subscriber by blood or adoption. Family plans, which are typically established for several siblings under age 18, are subject to the same contribution limits per beneficiary, but provide additional flexibility for the subscriber because the educational assistance payments that will be made are not be limited to each child's "share" of the contributions.

9-117. This feature is important when an individual has several children and not all of them pursue higher education. Because of the flexibility inherent in family plans, all of the plan distributions could be directed towards the children who are eligible to receive such funds. To ensure that family plans do not provide unintended benefits, no beneficiaries 21 years of age or older can be added to a family plan.

9-118. In terms of alternatives for investing the funds that have been contributed, there are basically two types of RESPs available. They can be described as follows:

**Scholarship Plans** are available through "scholarship trust companies" such as the Canadian Scholarship Trust Plan. These plans are distinguished by the fact that all of their funds must be invested in government guaranteed investments. These companies offer group plans (earnings are allocated only to those children who attend college or university), as well as individual plans (subscribers can recover their share of the investment earnings).

**Self-Directed Plans** allow investors to choose their own investments. The list of qualified investments is similar to that applicable to self-directed RRSPs. For example, publicly traded stocks are eligible, but income producing real estate is not. As is the case with RRSPs, there is no foreign content limit for self-directed RESPs.

## Refund Of Contributions

9-119. Contributions can be paid on a tax free basis to either the subscriber to the plan or to the beneficiary. The only limitations on such payments are those that might be included in the terms and conditions of the plan itself.

## Education Assistance Payments

9-120. Education assistance payments are amounts paid to student beneficiaries from accumulated earnings, CESG amounts, and CLB amounts. These amounts must be included in the income of the recipient.

9-121. To be eligible for the receipt of such amounts, the individual must be enrolled in a program at the post-secondary level that lasts at least three consecutive weeks. If the student spends not less than 10 hours per week on courses or work it is considered a **qualifying** educational program. If the student spends not less than 12 hours per month on courses or work it is considered a **specified** educational program. In the case of a specified educational program, the student must be at least 16 years old.

9-122. The limits on the amounts to be paid can be described as follows:

- For studies in a qualifying educational program, the limit is $5,000 for the first 13 consecutive weeks. Subsequent to that period, there is no limit on payments, provided the student continues to qualify.
- For studies in a specified educational program, the limit is $2,500 for the first 13 week period, whether or not the student is enrolled in the program throughout this period.

9-123. Note that CESG and CLB amounts can only be paid out as educational assistance payments to beneficiaries. If the beneficiary does not pursue post-secondary education, these benefits must be returned to the government.

### Accumulated Income Payments To Subscribers

9-124. Payments made to subscribers out of the accumulated income of the plan are referred to as accumulated income payments. To be eligible to receive such payments, the subscriber must be a resident of Canada. In addition, one of the following conditions must apply:

- The payment is made after the year that includes the 9th anniversary of the plan and, each beneficiary has reached the age of 21 years and is not currently eligible for educational assistance payments.
- The payments are made after the plan has been de-registered (35 or 40 years, depending on the type of plan).
- All of the beneficiaries are deceased.

9-125. The accumulated income payments will be included in the subscriber's Net Income For Tax Purposes and Taxable Income. In calculating the individual's Tax Payable, an additional tax of 20 percent of the accumulated income payments must be added to the total. This additional tax is designed to offset the fact that the individual has enjoyed tax free earnings compounding inside the RESP.

9-126. There is a provision which allows a taxpayer to reduce the amount of accumulated income payments that will be subject to the 20 percent additional tax. Provided the individual has sufficient RRSP contribution room (see Chapter 10 for coverage of this concept), accumulated income payments can be transferred to an RRSP. Such transfers will provide the individual with a deduction for the amounts of accumulated income payments and provide relief from the additional 20 percent tax. The limit on such transfers is $50,000 worth of accumulated income payments.

### Repayment Of CESG And CLB Contributions

9-127. As noted in Paragraph 9-123, amounts in the plan that reflect CESG or CLB contributions can only be distributed to a plan beneficiary as an educational assistance payment. They cannot be paid to subscribers.

9-128. In those situations where it is clear that no beneficiary will qualify for educational assistance payments, the plan will likely contain various types of balances. To the extent that these balances include CESG or CLB contributions, these amounts will have to be returned to the government. This means that a withdrawal is likely to include amounts that can be retained by the subscriber as well as amounts that must be repaid to the government.

9-129. Given this situation, a fairly complex set of rules is required to deal with withdrawals from the plan. Such withdrawals must be segregated into: the return of subscriber contributions, the withdrawals of accumulated earnings amounts, and the CESG and CLB contributions that must be repaid to the government. Coverage of these rules goes beyond the scope of this text.

**We suggest you work Self Study Problem Nine-6 at this point.**

## Comparison Of TFSAs And RRSPs

9-130. For individuals with sufficient resources to maximize contributions to all available types of registered savings plans, making contributions to a TFSA is a no-brainer. However, it appears that, in the real world, such individuals are rare. This means that, for most individuals, a choice must be made among the available alternatives.

9-131. While the range of available plans can be fairly large for some individuals, the most common choice will be between making contributions to a TFSA and making contributions to a Registered Retirement Savings Plan (RRSP). In comparing these two alternatives, the most significant differences can be described as follows:

- Contributions to an RRSP are tax deductible. Since contributions to a TFSA are not deductible, that means they are funded with after-tax dollars.
- Withdrawals from an RRSP are taxed as income. Withdrawals from a TFSA are not reported as income so they are not subject to tax and do not affect the OAS/EI clawback or government benefits such as the GST credit.

9-132. Although detailed coverage of RRSPs is found in Chapter 10 and a complete analysis of the impact of these differences goes beyond the scope of this text, a simple example will serve to illustrate their application.

> **EXAMPLE** In 2019, Sophia Scarponi has $5,000 in pre tax income that she does not need for current consumption. She has asked your advice on whether she should contribute to a TFSA or, alternatively to an RRSP. She indicates that her marginal tax rate is 45 percent, a rate that she expects to be the same for the next 10 years. She anticipates that funds invested in either type of plan will enjoy a compounded annual return of 10 percent. She does not anticipate needing the funds for at least 10 years.
>
> **ANALYSIS - TFSA** As the $5,000 is a pre tax amount, she will have after tax funds of $2,750 [($5,000)(1 - .45)] to invest in the TFSA. If this amount is left in the TFSA and earnings are compounded for 10 years at 10 percent, she will have a balance of $7,133. None of this amount will be subject to tax when it is withdrawn.
>
> **ANALYSIS - RRSP** As contributions to an RRSP are tax deductible, there will be no need to pay taxes on the $5,000 in pre tax income. This means that the full amount can be contributed. If the $5,000 is left in the RRSP and earnings are compounded for 10 years at 10 percent, the balance will be $12,969. If she withdraws this amount, she will have after tax funds of $7,133 [($12,969)(1 - .45)].

9-133. In this very simple example, the results under the two approaches are identical. Whether contributions are made to a TFSA or, alternatively, to an RRSP, Ms. Scarponi will wind up with after tax funds of $7,133. However, this result could be altered by a number of considerations. The most obvious factor would be her current tax rate vs. the tax rate after 10 years. If her current tax rate was higher than the rate after 10 years, her year 10 balance using a TFSA would be less than the after tax funds from an RRSP. If her current tax rate was lower, this would favour the use of a TFSA, especially if the OAS clawback was a factor.

## Comparison Of TFSAs, RRSPs And RESPs

9-134. As was noted in our preceding comparison of RRSPs and TFSAs, most families are not able to make maximum contributions to both RRSPs and TFSAs. The situation would be further complicated by the presence of a child or children eligible for the benefits of the RESP program. For an individual with $50,000 in earned income and a child whose RESP contribution would be eligible for a CESG grant, the total funds needed to make the maximum contributions for 2019 would be $17,500 [(18%)($50,000) RRSP + $6,000 TFSA + $2,500 RESP]. It is very unlikely that an individual earning $50,000 per year could divert such a sum from the amounts needed to maintain a family in a comfortable life style.

9-135. In terms of tax policy, it is worth noting that when one considers these choices as a group, it is clear that their cumulative effect benefits wealthy Canadians. To make maximum use of all these plans, the taxpayer would have to have either a very high level of income and/or a significant accumulation of unneeded resources. It is clear that the average Canadian working individual would rarely, if ever, be able to receive the maximum benefits available from these programs. This fact was recognized when the TFSA's annual limit was dropped from $10,000 in 2015 to $5,500 for 2016.

9-136. Facing this reality means that most taxpayers will have to make a choice as to which of these registered plans will receive the funds that they have available. We have previously covered some of the factors to be considered in making a choice between TFSAs and RRSPs. With respect to the choice between RRSPs and RESPs, the following points are relevant:

- A major advantage of RESPs relative to RRSPs is the fact that RESP contributions can be eligible for a Canada Education Savings Grant.
- A further advantage of RESPs relative to RRSPs is the fact that the establishment of such plans allows contributions to be made under the Canada Learning Bonds program. Note that this program could justify establishing an RESP for children in low income families, even if no contributions were made to the plan.
- A major advantage of RRSPs relative to RESPs is the fact that RRSP contributions are deductible in the calculation of Net Income For Tax Purposes. Given a particular before tax amount available, this allows for larger contributions to be made to RRSPs.
- Offsetting the deductibility of RRSP contributions, all payments out of RRSPs to plan beneficiaries are normally taxed. While some individuals may be in a lower tax bracket in the period of payment, many individuals will be taxed at the same rates as were applicable when their contributions were deductible. In contrast, RESP distributions are tax free to the extent they represent original contributions to the plan. Further, while RESP earnings are included in the student's income, a university or college student could have sufficient tax credits that no tax is paid on the earnings. As a result, a student can receive a significant amount of income tax free. Even when taxes must be paid, all amounts are likely to be taxed in the minimum tax bracket.
- Both RRSPs and RESPs offer the advantage of having earnings compound on a tax free basis. As is illustrated in detail in Chapter 10, this is a very powerful mechanism for tax deferral. In this area, an advantage for RRSPs is that the tax free compounding period is potentially longer.
- Canada Child Benefit payments are income tested. Because the contributions are deductible, using an RRSP can reduce family income and, in some situations, increase the amount of the Canada Child Benefit payments.

9-137. In comparing the features of TFSAs vs. RESPs we would add the following points:

- The major advantage of RESPs as compared to TFSAs is the availability of CESG and CLB contributions made by the government.
- The major disadvantage of RESPs as compared to TFSAs is the fact that when earnings are withdrawn they can be subject to tax. Taxation may be avoided if the earnings are distributed to a qualifying student with sufficient credits to eliminate the taxes. However, there is the possibility the beneficiary of the plan may not pursue post-secondary education. In this case, the earnings will be taxed in the hands of the subscribers and subject to the 20 percent penalty.

9-138. In real world situations, the majority of taxpayers will be forced to make a choice in allocating available funds between these registered plans. As the preceding discussion makes clear, an optimum choice involves a great many assumptions about future events, earnings rates, and tax rates. The complexity that is involved making the required allocation decisions is likely to be well beyond the understanding of most individual taxpayers.

## Registered Disability Savings Plans (RDSPs)

### *The Problem*

9-139. Parents of children who are severely disabled are usually faced with a life-long commitment for care and support of these children. Further, the needs of these disabled individuals for care and support may extend well beyond the lifetime of the parents. Parents facing this possibility would like to ensure that the needed care and support is, in fact, available as long as it is required.

### *The Solution*

9-140. The government's solution to this problem is legislation which provides for Registered Disability Savings Plans (RDSPs). The mechanics of RDSPs are largely the same as those applicable to RESPs. The general features of these plans are as follows:

- Non-deductible contributions are made to a registered trust with the disabled person as beneficiary.
- The contributions are invested with earnings accumulating on a tax free basis. There is no annual limit. However, contributions are limited to $200,000 over the beneficiary's lifetime.
- The government will supplement contributions to these plans through Canada Disability Savings Grants and Canada Disability Savings Bonds in a manner similar to Canada Education Savings Grants and Canada Learning Bonds.
- Disability assistance payments are made out of the plan assets to the disabled individual. These payments will be divided between a tax free amount which reflects the contributions made to the plans, and a taxable amount which reflects distributions of accumulated earnings.

9-141. There are many additional rules related to RDSPs, some of them quite complex. Because of this complexity, as well as the fact that these plans are not as widely used as other registered plans, we will not provide detailed coverage of RDSPs. If you have further interest in RDSPs, we would refer you to the CRA's *Registered Disability Savings Plans* (RC4460).

# Non-Arm's Length Transfers Of Property

## Introduction

### *The Problem*

9-142. When a capital asset is transferred between arm's length persons, there is an assumption that the transaction takes place at fair market value. Under the usual rules for capital asset dispositions, this fair market value will be used as both the adjusted cost base or capital cost for the newly acquired asset, as well as for the proceeds of disposition to the person disposing of the asset. These proceeds of disposition will then be used to determine tax consequences to the person disposing of the asset (e.g., capital gain or loss).

9-143. When a non-arm's length transaction is involved, the fair market value assumption cannot be relied on. While many non-arm's length transactions do, in fact, take place at fair market value, there are many situations where it would be to the advantage of a taxpayer to make the transfer at some value that is above or below fair market value (e.g., an individual selling an asset with an accrued capital gain to his low-income spouse for proceeds below fair market value).

9-144. This situation is further complicated by the fact that the *Income Tax Act* has special rules for determining the UCC when there has been a non-arm's length transfer of depreciable assets. In addition, there are rollover provisions that apply to certain types of non-arm's length transactions.

9-145. In this material on non-arm's length transactions, we will deal with the following provisions of the *Income Tax Act*:

**ITA 69 - Inadequate Considerations** This Section provides rules for dealing with situations where there has been a non-arm's length transfer at a value that is above or below fair market value (including gifts).

**ITA 73(1) And (1.01)** These Subsections provide for a tax free rollover of capital properties to a spouse or common-law partner.

**ITA 73(3.1) And (4.1)** These Subsections provide for a tax free rollover of a farming or fishing property to a child.

**ITA 13(7)(e)** This Paragraph provides special rules for dealing with non-arm's length transfers of depreciable property.

### Non-Arm's Length Defined

9-146. ITA 251(1), in effect, defines the term, "arm's length", by noting that for purposes of the *Act* "related persons shall be deemed not to deal with each other at arm's length". With respect to individuals, ITA 251(2)(a) points out that they are related if they are connected by blood relationship, marriage, common-law partnership or adoption.

9-147. With respect to the question of whether corporations are related, ITA 251(2)(b) and (c) have a fairly long list of possibilities. For example, a corporation is related to the person who controls it, and two corporations are related if they are both controlled by the same person. There are, of course, many complications in this area. However, the examples used in this Chapter involve only situations in which the taxpayers are obviously related. More complex situations will be considered in our coverage of corporate taxation.

## Inadequate Considerations - ITA 69

### The Problem

9-148. As we have noted, when a transfer of capital property takes place between taxpayers who are dealing with each other at arm's length, there is usually no reason to assume that the transfer took place at a value that was significantly different from the fair market value of the property transferred. In fact, fair market value is often described as the value that would be used by arm's length parties in an exchange transaction.

9-149. The consideration given for the property would normally be used as both the proceeds of the disposition for the vendor and the adjusted cost base for the new owner. However, when a transfer takes place between taxpayers who are not dealing at arm's length, there is the possibility that the consideration can be established at a level that will allow one or both taxpayers to reduce or avoid taxes.

**EXAMPLE** During 2019, Martin Horst, whose marginal federal tax rate is 29 percent, sells a property with a fair market value of $200,000 to his 25 year old son for its adjusted cost base of $150,000. The son, who has no other source of income in 2019, immediately sells the property for its fair market value of $200,000. The son's only tax credit is the basic personal credit of $1,810.

**ANALYSIS** If Martin had sold the property for its fair market value of $200,000, he would have paid federal taxes of $7,250 [($200,000 - $150,000)(1/2)(29%)]. In contrast, if the $50,000 capital gain was taxed in the hands of his son, the federal tax would only be $1,940 {[($200,000 - $150,000)(1/2)(15%)] - $1,810}, a savings of $5,310 ($7,250 - $1,940) at the federal level alone.

9-150. The preceding example illustrates the problem associated with non-arm's length transfers at values below fair market value. In addition, there are two other situations which require special rules. These are:

- A transfer at a positive amount that is below fair market value.
- A transfer for nil consideration (i.e., a gift).

9-151. Section 69 of the *Income Tax Act*, which is somewhat inappropriately titled "Inadequate Considerations", provides rules for dealing with each of these situations.

## General Rules

9-152. When a transfer occurs at fair market value, the general rules for determining capital gains and losses are applicable. However, as described in Paragraph 9-150, there are three possible situations that create potential problems. The tax rules for fair market value transfers, and for the three situations described in Paragraph 9-150, are outlined in Figure 9-2.

**Figure 9 - 2 Non-Arm's Length Transfers - ITA 69**

| Transfer Price | Proceeds Of Disposition For Transferor | Adjusted Cost Base For Transferee |
|---|---|---|
| Fair Market Value | Fair Market Value | Fair Market Value |
| Above Fair Market Value | Actual Proceeds | Fair Market Value |
| Below Fair Market Value | Fair Market Value | Actual Proceeds |
| Nil (Gift) | Fair Market Value | Fair Market Value |

## Example

9-153. In order to illustrate the rules presented in Figure 9-2, assume that John Brown has a capital asset with an adjusted cost base of $50,000 and a fair market value of $75,000. If the asset is sold for consideration equal to its fair market value of $75,000, the result will be a capital gain of $25,000 for John Brown and an adjusted cost base for the new owner of $75,000. This would be the result without regard to whether the purchaser was at arm's length with John Brown.

9-154. If the asset is transferred to a non-arm's length party, and the consideration provided is not equal to its fair market value, ITA 69 becomes applicable. The following three Cases illustrate the various possible alternatives. In each Case, we will assume the transfer is to John Brown's adult brother, Sam Brown.

> **Case A - Transfer At $100,000 (Above Fair Market Value)** In this case, there is no special rule for the transferor. Given this, the proceeds to John Brown will be the actual amount of $100,000 and will result in an immediate capital gain to John Brown of $50,000 ($100,000 - $50,000). The adjusted cost base to Sam Brown will be limited by ITA 69(1)(a) to the $75,000 fair market value. This means that $25,000 of the amount that he has paid is not reflected in his adjusted cost base. If, for example, Sam Brown were to sell the asset for $100,000 (the amount he paid), he would have a capital gain of $25,000 ($100,000 - $75,000) and there will have been double taxation of the $25,000 difference between the transfer price of $100,000 and the fair market value of $75,000.

> **Case B - Transfer At $60,000 (Below Fair Market Value)** If the transfer took place at a price of $60,000, ITA 69(1)(b) would deem John Brown to have received the fair market value of $75,000. As there is no special rule applicable to the purchaser in this case, the adjusted cost base to Sam Brown would be the actual transfer price of $60,000. Here again, double taxation could arise, this time on the difference between the transfer price of $60,000 and the fair market value of $75,000.

> **Case C - Gift, Bequest, Or Inheritance** In this case, ITA 69(1)(b) would deem the proceeds of disposition to be the fair market value of $75,000, and ITA 69(1)(c) would deem Sam Brown's adjusted cost base to be the same value. Note that this is the same result that would be achieved if the asset was sold to Sam Brown at its fair market value of $75,000. However, there is no double taxation involved in this Case.

9-155. Given the presence of ITA 69, the general rules for transferring property to related parties are very clear. Either transfer the property at a consideration that is equal to its fair market value or, alternatively, gift the property. A non-arm's length transfer, at a value that is either above or below the fair market value of the property, will result in double taxation on some part of any gain recognized when there is a later sale of the property by the transferee.

### Applicability Of ITA 69

9-156. The inadequate consideration rules in ITA 69 are prefaced by the phrase "except as expressly otherwise provided in this Act". This means that if there is a provision that deals with a particular non-arm's length transfer, that provision takes precedence over the general provisions of ITA 69. Examples of such situations that are discussed later in this Chapter are the transfers to a spouse covered in ITA 73(1) and the transfers of farm property to a child covered in ITA 73(3.1). When these provisions are applicable, ITA 69 is not applicable.

## Exercise Nine - 8

**Subject:** Inadequate Consideration - Non-Depreciable Property

Mr. Carl Lipky owns a piece of land with an adjusted cost base of $100,000 and a fair market value of $75,000. He sells the land to his brother for $95,000 who immediately sells it for $75,000. Determine the amount of any capital gain or loss to be recorded by Mr. Lipky and his brother.

**SOLUTION available in print and online Study Guide.**

### Using Leases To Avoid ITA 69

9-157. At one point, it was possible to avoid the provisions of ITA 69 through the use of leasing arrangements. These arrangements involved the rental of a property to a person with whom the owner/lessor was not dealing at arm's length. The required lease payment was set at a sufficiently low level that the fair market value of the property was significantly reduced. This would allow a sale or gift to be made, with the deemed proceeds of disposition being based on this lower value.

9-158. As an example of this type of arrangement, consider a situation where an individual has a property with a fair market value of $100,000. If this property was leased on a long-term basis to a spouse or common-law partner for an unrealistically low value, say $2,000 per year, the fair market value of the property might be reduced to about $20,000. If there were no restrictions, it could then be gifted or sold for $20,000 to a child, and there would be no double taxation under the provisions of ITA 69.

9-159. ITA 69(1.2) is designed to make this an unattractive strategy. Under the provisions of this Subsection, the taxpayer's proceeds of disposition on the gift or sale will be the greater of the actual fair market value at the time of the disposition ($20,000) and the fair market value determined without consideration of the non-arm's length lease ($100,000). This means the transferor will be taxed on the basis of having received the full $100,000 and, under the usual provisions of ITA 69, the transferee will have an adjusted cost base of $20,000. This will result in double taxation of the difference between $100,000 and $20,000 and should serve to discourage this type of avoidance strategy.

## Exercise Nine - 9

**Subject:** Inadequate Consideration - Leased Property

Mr. Ned Bates has land with an adjusted cost base of $33,000 and an unencumbered fair market value of $211,000. He leases this land to his wife for $3,300 per year, for a period of 35 years. Similar leases are based on 10 percent of the value of the property and, as a consequence, the fair market value of the land with the lease in place falls to $33,000. He sells the land to a corporation controlled by his wife for this reduced value. Determine the amount of capital gain or loss to be recorded by Mr. Bates as a result of this sale, as well as the adjusted cost base of the land to the corporation.

**SOLUTION available in print and online Study Guide.**

**We suggest you work Self Study Problem Nine-7 at this point.**

# Inter Vivos Transfers To A Spouse - ITA 73(1) And 73(1.01)

## General Rules For Capital Property

9-160. An inter vivos transfer is one that occurs while the transferor is still alive, rather than at the time of, or subsequent to, that individual's death. ITA 73(1) contains special rules for certain qualifying transfers as described in ITA 73(1.01). These qualifying transfers are:

- a transfer to the individual's spouse or common-law partner;
- a transfer to the individual's former spouse or former common-law partner in settlement of rights arising out of their marriage or common-law partnership; and
- a transfer to a trust for which the individual's spouse or common-law partner is the income beneficiary (this type of trust has traditionally been referred to as a spousal trust and the conditions related to this concept are discussed in Chapter 19).

9-161. For the qualifying transfers listed in ITA 73(1.01), ITA 73(1) specifies rules that provide a tax free transfer (such tax free transfers are commonly referred to by tax professionals as rollovers). With respect to the proceeds of disposition for the transferor, the rules for capital property depend on whether it is depreciable or non-depreciable and are as follows:

**Proceeds - Non-Depreciable** The proceeds will be deemed to be the adjusted cost base of the property transferred.

**Proceeds - Depreciable** The proceeds will be deemed to be the UCC of the class or, if only part of a class is transferred, an appropriate portion of the class.

9-162. From the point of view of the transferee, ITA 73(1) indicates that he will be deemed to have acquired the capital property at an amount equal to the deemed proceeds to the transferor. Based on this, his values will be as follows:

**Tax Cost - Non-Depreciable** The cost to the transferee will be deemed to be the adjusted cost base to the transferor.

**Tax Cost - Depreciable** The UCC to the transferee will be the old UCC to the transferor. However, under ITA 73(2), the old capital cost will also be retained by the transferee, with the difference between this and his UCC being considered to be deemed CCA. This rule is very important in that it ensures that if the property is subsequently sold for a value between the old capital cost and the old UCC, the excess over the UCC will be treated as fully taxable recapture, not a capital gain, only one-half of which would be taxed.

9-163. These rules mean that the transfer will have no tax consequences for the transferor and that the transferee will retain the same tax values that were contained in the transferor's records. This is illustrated by the following example:

**EXAMPLE** Marg Cardiff gifts land with an adjusted cost base of $100,000 and a fair market value of $250,000 to her husband, Bernie. At the same time, her Class 10 assets are also given to Bernie. The Class 10 assets have a capital cost of $225,000 and a fair market value of $310,000. The UCC for Class 10, prior to the gift, is $195,000.

**ANALYSIS** Marg would be deemed to have received $100,000 for the disposition of the land and $195,000 for the Class 10 assets.

Given these values, the transactions would have no tax consequences for Marg.

For Bernie, the land would have an adjusted cost base of $100,000.

The transferred Class 10 assets would have a UCC of $195,000, combined with a capital cost of $225,000. This means that, if Bernie sold all the transferred assets immediately for their combined fair market value of $560,000 ($250,000 + $310,000), there would be a capital gain of $150,000 ($250,000 - $100,000) on the land, a capital gain of $85,000 ($310,000 - $225,000) on the Class 10 assets, as well as recapture of CCA of $30,000 ($195,000 - $225,000) on the Class 10 assets.

Note that these are the same tax consequences that would have occurred if Marg had simply sold the assets to an arm's length party.

## Electing Out Of The Spousal Rollover

9-164. The ITA 73(1) rollover automatically applies to spousal rollovers unless the taxpayer takes positive action to remove its applicability. However, the taxpayer can elect out of this approach if he wishes to recognize capital gains or recapture at the time of the transfer. There are a variety of reasons that a taxpayer may wish to make this election. For example, if a taxpayer has unused allowable capital losses, he could choose to trigger taxable capital gains to make use of these losses. Electing out of the ITA 73(1) rollover can also be important when dealing with income attribution. This issue is discussed later in this Chapter.

9-165. With respect to the process of electing to be taxed on an inter vivos spousal transfer, ITA 73(1) uses the phrase "elects in his return of income". The use of this phrase in the *Income Tax Act* means there is no official tax form required in order to make the election. In contrast, in situations where a form is required, the usual *Income Tax Act* terminology is the phrase "elects in the prescribed manner".

9-166. For a taxpayer wishing to elect out of ITA 73(1), the only requirement is that they include any income resulting from the spousal transfer in their tax return in the year of disposition.

**EXAMPLE - Continued** In the example from Paragraph 9-163, Marg could have elected to record the land transaction at the fair market value of $250,000, resulting in a $150,000 capital gain being recorded at the time of transfer. In this case, the adjusted cost base to Bernie would be $250,000. The election would be made by simply including the $75,000 taxable portion of the $150,000 gain in Marg's tax return.

9-167. You should note that, if the taxpayer elects out of ITA 73(1), ITA 69 becomes applicable. This means that, in such situations, if the transfer is not a gift, or is made in return for consideration that is not equal to the fair market value of the property, the ITA 69 provisions will result in double taxation as was discussed previously. In addition, if a depreciable asset is transferred, special rules apply when calculating the transferee's capital cost. These rules are covered in the next section of this Chapter.

### Exercise Nine - 10

**Subject:** Inter Vivos Transfer Of Non-Depreciable Asset To A Spouse

Aaron Schwartz owns land with an adjusted cost base of $225,000 and a fair market value of $300,000. He sells this land to his spouse for its fair market value of $300,000. Indicate the tax consequences to Mr. Schwartz and the adjusted cost base of the property to his spouse after the sale assuming Mr. Schwartz does not elect out of ITA 73(1). How would your answer change if Mr. Schwartz elects out of ITA 73(1)?

**SOLUTION available in print and online Study Guide.**

## Non-Arm's Length Transfers Of Depreciable Assets - ITA 13(7)(e)

### *Problem 1 - Fair Market Value Exceeds Transferor's Capital Cost*

9-168. The problem here relates to the fact that, if the transfer is made at a value in excess of the transferor's capital cost, the result will be a capital gain, only one-half of which will be taxed. If the full amount of the capital gain was added to the transferee's UCC, it would form the basis for fully deductible CCA.

**EXAMPLE** Jean Tessier has a depreciable asset with a fair market value of $150,000, a capital cost of $110,000, and a UCC of $85,000. It is the only asset in the Class. He sells this asset to his daughter Francine for its fair market value of $150,000.

**ANALYSIS** As a result of this disposition, Jean will have recapture of $25,000 ($110,000 - $85,000) and a capital gain of $40,000 ($150,000 - $110,000). Only $20,000 of this capital gain will be subject to tax, resulting in a total increase in his Taxable Income of $45,000 [$25,000 + (1/2)($40,000)].

If Francine was allowed to record the $150,000 as her capital cost for CCA purposes, she would be able to deduct 100 percent of this amount as CCA. This means that, by increasing his Taxable Income by $45,000, the future deductions available on this asset would have increased by $65,000 ($150,000 - $85,000). As related parties, Jean and Francine would clearly have an incentive to make the transfer at this price.

### *Solution To Problem 1*

9-169. Tax legislation acts to prevent such non-arm's length transfers from having this benefit. In those situations where the transfer occurs at a value that exceeds the transferor's capital cost, for the purposes of CCA and recapture calculations **ONLY**, ITA 13(7)(e) deems the transferee's capital cost to be equal to:

$$\mathbf{A + [(1/2)(B - A)]}, \text{ where:}$$

**A** = The Transferor's Old Capital Cost
**B** = The Transferee's New Capital Cost

ITA 13(7)(e) is not applicable when the transfer results from the death of a taxpayer.

**ANALYSIS - Continued** Applying this rule to the example in Paragraph 9-168, Francine's capital cost and UCC balance would be $130,000 [$110,000 + (1/2)($150,000 - $110,000)]. As a result, the transfer has increased the UCC by $45,000 ($130,000 - $85,000), an amount equal to the increase in Jean's Taxable Income resulting from the transfer.

It is important to note that the $130,000 is only used for recapture and CCA calculations. The capital cost for capital gains purposes would be based on the actual transfer price of $150,000. Assuming Francine later sold the asset for $160,000 without taking any CCA, the taxable capital gain would be $5,000 [(1/2)($160,000 - $150,000)] and there would be no recapture.

| | |
|---|---|
| UCC Balance At Time Of Sale | $130,000 |
| Deduct Lesser Of: | |
| • Deemed Capital Cost For CCA Purposes = $130,000 | |
| • Proceeds Of Disposition = $160,000 | ( 130,000) |
| Recapture | Nil |

If these procedures look familiar, they are very similar to those applicable when there is a change in use from personal to business use and the fair market value of the asset exceeds its capital cost. (See coverage of ITA 13(7)(b) in Chapter 8.)

### Problem 2 - Fair Market Value Less Than Transferor's Capital Cost

9-170. A similar problem arises when a non-arm's length transfer occurs at a value that is less than the transferor's capital cost.

**EXAMPLE** Carole Dupre has a depreciable asset with a fair market value of $200,000, a capital cost of $325,000, and a UCC of $150,000. It is the only asset in the Class. She sells this asset to her son Marcel for the fair market value of $200,000.

**ANALYSIS** As a result of this transaction, the only tax consequence for Carole would be recapture of $50,000 ($150,000 - $200,000).

Under the usual rules, the capital cost to Marcel would be the transfer price of $200,000. The problem with this result is that, if Marcel were to later sell this asset for $250,000, the difference between the $250,000 and this $200,000 would be treated as a capital gain, only one-half of which would be included in his Taxable Income. In contrast, if Carole had sold the asset for $250,000, the difference would have been fully taxable recapture. As in the problem 1 scenario, this situation provides an incentive for Carole and Marcel to make the transfer at this price.

### The Solution To Problem 2

9-171. When there is a non-arm's length transfer at a value that is less than the transferor's capital cost, the ITA, including 13(7)(e), deems the transferee's capital cost, for both CCA and capital gains calculations, to be equal to the transferor's old capital cost.

**ANALYSIS - Continued** Applying this rule to the example in Paragraph 9-170, the deemed capital cost to Marcel would be $325,000, with the $125,000 difference between this amount and the $200,000 paid considered to be deemed CCA. When this rule is applied, a sale by Marcel at $250,000 would result in fully taxable recapture of $50,000 ($200,000 - $250,000). The $250,000 is the lesser of the proceeds of disposition of $250,000 and the deemed capital cost (equal to Carole's capital cost) of $325,000. Unlike the previous case where the transfer is at a value that is greater than the transferor's capital cost, the $325,000 deemed capital cost would be used for determining capital gains as well as for determining recapture.

### Application Of ITA 69

9-172. These rules for non-arm's length transfers of depreciable property apply to all such transactions, including those to which ITA 69 is applicable. In such situations, the ITA 13(7)(e) rules will be applied using the amounts that are required by this section. However, the application of ITA 69 to transfers of depreciable assets is very complex. In addition, there are some who believe that the *Income Tax Act* is not entirely clear on how these provisions interact. Given this, we will not include coverage in this text of non-arm's length transfers of depreciable assets at a positive amount that is not fair market value.

## Exercise Nine - 11

**Subject**: Inter Vivos Transfer Of Depreciable Asset To A Spouse

During the current year, Mary Sharp transferred a depreciable property to her spouse. The property had a fair market value of $225,000, a capital cost of $175,000, and a UCC of $110,000. It is the only asset in its class. In return for the property, she received $225,000 in cash. Describe the tax consequences to Ms. Sharp and her spouse, assuming that she does not elect out of ITA 73(1). How would your answer change if she elects out of the rollover provision?

**SOLUTION available in print and online Study Guide.**

## Exercise Nine - 12

**Subject**: Inter Vivos Transfer Of Depreciable Property To A Parent

Ms. Jennifer Lee owns a depreciable asset that she has used in her unincorporated business. It has a cost of $53,000 and a fair market value of $40,000. It is the only asset in its CCA class, and the UCC balance in the class is $37,200. Ms. Lee sells the asset to her father for the fair market value of $40,000. During the same year, prior to deducting any CCA, the father resells the asset for $44,000. Determine the amount of income to be recorded by Ms. Lee and her father as a result of these transactions.

**SOLUTION available in print and online Study Guide.**

**We suggest you work Self Study Problem Nine-8 at this point.**

## Inter Vivos Transfer Of Farm Or Fishing Property To A Child

9-173. ITA 73(3.1) and (4.1) provide for direct inter vivos transfers of farm or fishing property, shares of family farm or fishing corporations, or interests in family farm or fishing partnerships, to children on a tax-free basis. As was the case with ITA 73(1), the provisions of ITA 73(3.1) and (4.1) take precedence over the provisions of ITA 69.

9-174. For the purposes of this Section, "child" refers to children and their spouses, grandchildren, great grandchildren, and any other person who, prior to reaching the age of 19, was dependent on the taxpayer and under his custody or control. To qualify, the child must be a resident of Canada at the time of the transfer. In addition, the property must be in use in a farming or fishing business operated by the taxpayer, the taxpayer's spouse, or any of their children.

9-175. The transfer is deemed to have taken place at the actual proceeds of disposition, restricted by floor and ceiling amounts.

For **Depreciable Property**, the floor is the property's UCC, while the ceiling is its fair market value. The transferee would retain the original capital cost to the transferor with the difference being treated as deemed CCA.

For **Non-Depreciable Property**, which includes shares in a farm or fishing corporation, the floor is the adjusted cost base, while the ceiling is the fair market value.

9-176. The following example will illustrate these floor and ceiling rules.

**EXAMPLE** Tim Johnson's farm consists of land with an adjusted cost base of $200,000 and a fair market value of $350,000, and depreciable assets with a UCC of $400,000, a capital cost of $550,000, and a fair market value of $675,000. It is transferred to Tim's son.

**ANALYSIS - Land** If the transfer is for proceeds of disposition below $200,000 (this includes gifts), the deemed proceeds of disposition and adjusted cost base to the child would be $200,000. If the transfer is for an amount in excess of $350,000, the deemed proceeds of disposition and adjusted cost base to the child would be limited to $350,000. For transfers between $200,000 and $350,000, the actual proceeds of disposition would be used.

**ANALYSIS - Depreciable Property** For transfers below the UCC of $400,000, (including gifts), the deemed proceeds of disposition and transfer price to the child would be $400,000. Correspondingly, for transfers above $675,000, the deemed proceeds of disposition and capital cost to the child would be $675,000. For transfers between $400,000 and $675,000, the actual proceeds of disposition would be used.

## Exercise Nine - 13

**Subject**: Inter Vivos Farm Property Transfer To A Child

Thomas Nobel owns farm property consisting of land with an adjusted cost base of $250,000 and a fair market value of $325,000, along with a barn with a UCC of $85,000, a capital cost of $115,000, and a fair market value of $101,000. The property is transferred to his 40 year old daughter in return for a payment of $280,000 for the land. No payment is made for the barn. Describe the tax consequences of this transfer, both for Mr. Nobel and for his daughter.

**SOLUTION available in print and online Study Guide.**

# Death Of A Taxpayer

## General Rules

9-177. There are many special rules that may be applicable when an individual dies. In this Chapter, we cover the rules related to capital property. Other material on the death of a taxpayer can be found in the Chapter 11 Appendix titled "Returns For Deceased Taxpayers".

9-178. ITA 70(5) provides the following general rules for the capital property of a deceased taxpayer:

**Capital Property Other Than Depreciable Property** In general, the deceased taxpayer is deemed to have disposed of the property at fair market value immediately before his death. The person receiving the property is deemed to have acquired the property at this time, at a value equal to its fair market value.

**Depreciable Property** The basic rules for this type of property are the same. That is, there is a deemed disposition of the property by the deceased taxpayer at fair market value, combined with an acquisition of the property at the same value by the beneficiary. When the fair market value is less than the capital cost of the property for the deceased taxpayer, the beneficiary is required to retain the original capital cost, with the difference being treated as deemed CCA.

9-179. A simple example will serve to illustrate the rules for depreciable property:

**EXAMPLE** Eric Nadon dies, leaving a depreciable property to his son that has a capital cost of $100,000, a fair market value of $60,000, and a UCC of $50,000.

**ANALYSIS** Under ITA 70(5), the transfer will take place at the fair market value of $60,000. This means that Mr. Nadon's final tax return will include recaptured CCA of $10,000 ($60,000 - $50,000). While the son's UCC will be the $60,000 transfer price, the capital cost of the asset will remain at Mr. Nadon's original capital cost of $100,000. This means that, if the asset is later sold for a value between $60,000 and $100,000, the resulting gain will be treated as recaptured CCA, rather than as a more favourably taxed capital gain.

9-180. These deemed disposition rules apply to all capital property, including personal use property and listed personal property.

## Rollover To A Spouse, A Common-Law Partner, Or A Spousal Trust

9-181. ITA 70(6) provides an exception to the general rules contained in ITA 70(5) in situations where the transfer is to a spouse, a common-law partner, or a testamentary spousal or common-law partner trust. This is a rollover provision that allows the transfer of non-depreciable property at its adjusted cost base and depreciable property at its UCC.

9-182. This means that the transfer does not generate a capital gain or loss, recapture, or terminal loss, and that the surviving spouse or common-law partner will assume the same property values as those carried by the deceased. This has the effect of deferring any capital gains or recapture until the surviving spouse or common-law partner disposes of the property, or dies. As is the case with other transfers at death, if the transfer involves depreciable property, the deceased's old capital cost is retained.

9-183. It is possible for the legal representative of the deceased to elect in the taxpayer's final return to have one or all asset transfers take place at fair market value. This election could be used to take advantage of charitable donations, medical expenses, unused loss carry forwards, and, in the case of qualified farm property, qualified fishing property, or the shares of a qualified small business corporation, an unused lifetime capital gains deduction. As was the case with electing out of the ITA 73 inter vivos transfer to a spouse rules, electing out of ITA 70(6) is implemented in the deceased's final tax return and does not require the filing of a form.

9-184. To qualify as a spousal testamentary trust, ITA 70(6) indicates that the surviving spouse or common-law partner must be entitled to receive all of the income of the trust that arises before the death of the surviving spouse or common-law partner. In addition, no person other than the spouse or common-law partner may receive the use of any of the income or capital of the trust, prior to the death of this spouse or common-law partner.

9-185. Detailed coverage of spousal testamentary trusts can be found in Chapter 19. As discussed in Chapter 19, there are at least two advantages to using a spousal trust:

- Such arrangements can provide for the administration of the assets of the deceased in those situations where the surviving spouse or common-law partner is not experienced in business or financial matters.
- Such arrangements can allow the deceased to determine the ultimate disposition of any property that is left to the spousal trust. For example, if a father wishes the property he bequeathed to the spousal trust to go to his children after his wife's death, this can be specified in the trust arrangement. This would avoid the possibility that his widow might sell it, or redirect the property to a new husband or any children that she might have on remarrying.

## Exercise Nine - 14

**Subject:** Transfers On Death

Ms. Cheryl Lardner, who owns two trucks that were used in her business, dies in July, 2019. Her will transferred truck A to her husband, Michel, and truck B to her daughter, Melinda. Each of the trucks cost $42,000 and had a fair market value at the time of her death of $33,000. The UCC balance for the class that contains the trucks was $51,000. What are the tax consequences resulting from Ms. Lardner's death with respect to these two trucks? Your answer should include the capital cost and the UCC for the trucks in the hands of Michel and Melinda.

**SOLUTION available in print and online Study Guide.**

### *Tax Free Transfers Of Farm And Fishing Property At Death*

9-186. As we have seen, the most common situation in which capital property can be transferred at the time of death on a tax free basis is when the transfer is to a spouse or a spousal testamentary trust. However, ITA 70(9) through ITA 70(9.31) provides for other tax free transfers involving specific types of farm and fishing assets. For each of the following types of transfers, the legal representatives of the deceased can elect to transfer the property at any value between its tax value and its fair market value. These elections can be used to utilize any accumulated losses of the deceased, or any unused lifetime capital gains deduction.

- **Farm Or Fishing Property** When farm or fishing property has been used by a taxpayer or the taxpayer's family, it can be transferred on a tax free basis to a resident child, grandchild, or great grandchild at the time of the taxpayer's death. These provisions can also be used to transfer farm or fishing property from a child to a parent in situations where the child dies before the parent.
- **Shares Of A Family Farm Or Fishing Corporation** Shares of a family farm or fishing corporation can be transferred on a tax free basis to a resident child, grandchild, or great grandchild at the time of a taxpayer's death. It is possible to have tax free transfers of farm or fishing corporation shares from a child to a parent and, in addition, the rules provide for the rollover of shares in a family farm or fishing holding company.
- **Interests In Family Farm Or Fishing Partnerships** Rules similar to those described in the two preceding bullets allow for the tax free transfer of interests in family farm or fishing partnerships to a resident child, grandchild, or great grandchild at the time of the taxpayer's death. Here again, it is possible to have a tax free transfer from a child to a parent in the event of the child's death.

**We suggest you work Self Study Problem Nine-9 at this point.**

# Income Attribution

## The Problem

9-187. In the general discussion of tax planning in Chapter 1, it was noted that income splitting can be the most powerful tool available to individuals wishing to reduce their tax burden. The basic goal is to redistribute income from an individual in a high tax bracket to related individuals, usually a spouse or children, in lower tax brackets. As was illustrated in Chapter 1, when such redistribution can be achieved, it can produce very dramatic reductions in the aggregate tax liability of the family unit.

9-188. It is obvious that, if there were no restrictions associated with transfers of property to related persons, there would be little standing in the way of a complete equalization of tax rates within a family unit and the achievement of maximum income splitting benefits. For many years, it has been the policy of the government to tightly control access to the tax benefits of income splitting and, as a consequence, we have a group of legislative provisions that are commonly referred to as the income attribution rules.

9-189. These attribution rules could be criticized on the basis of fairness. Many of the most effective income splitting scenarios are complicated and involve the use of complex corporate, partnership, and trust structures. This level of income splitting requires the kind of sophisticated tax assistance that is available only to wealthy Canadians.

9-190. As mentioned in our coverage of pension income splitting (Paragraph 9-69), there are ways to legitimately split income with family members. However, there are many other potential income splitting opportunities that the attribution rules are designed to prevent. If the income attribution rules apply to an asset transfer to a lower income family member, the income from the transferred asset will be taxed in the hands of the transferor and no tax savings will be achieved.

## Basic Rules - ITA 74.1(1) And (2)

### *Applicable Individuals*

9-191. The income attribution rules are applicable to situations where an individual has transferred property to:

- a spouse or common-law partner [ITA 74.1(1)]; or
- an individual who is under the age of 18 and who does not deal with the individual at arm's length [ITA 74.1(2)].

9-192. The ITA 74.1(2) rules are applicable, not just to children or grandchildren under the age of 18, but to any non-arm's length individual who is under the age of 18. In addition, this Subsection specifically notes that nieces and nephews are subject to these rules, even though they are not non-arm's length individuals as defined in the *Income Tax Act*.

9-193. The general idea here is that, unless certain conditions are met, income associated with the transferee holding or disposing of a transferred property may be attributed back to the transferor of the property (i.e., included in the Net Income For Tax Purposes of the transferor). You should also note that losses can be transferred under the attribution rules, a fact that can be used by tax planners to reduce the tax liability of the transferor.

## Applicable To Property Income And Capital Gains

9-194. There are two types of income that may be attributed under these rules. The first type would be property income, such as interest, dividends, rents, and royalties, which accrues while the transferee is holding the transferred assets. This type of income may be attributed back to the transferor without regard to whether the transferee is a spouse, common-law partner, or a related individual under the age of 18.

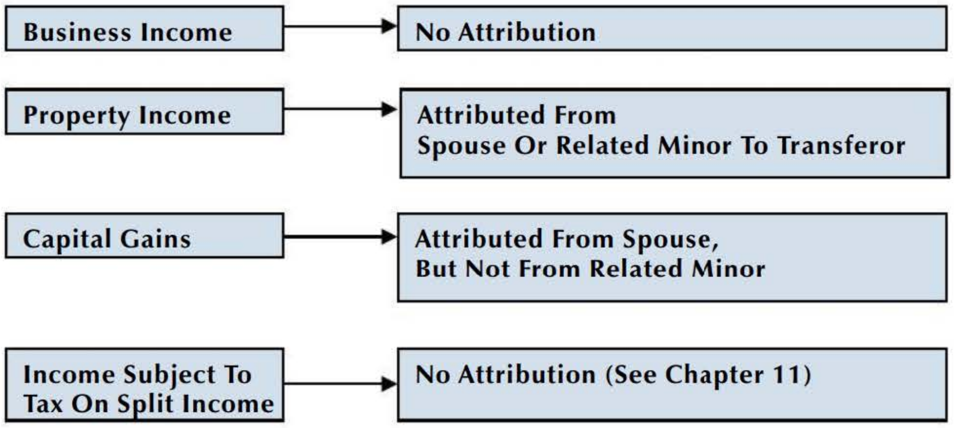
9-195. The second type of income that may be subject to the attribution rules is capital gains resulting from a disposition of the transferred property. Whether or not this type of income is subject to the attribution rules will depend on the relationship of the transferee to the transferor:

> **Transfers To A Spouse** When property is transferred to a spouse or common-law partner, the application of the ITA 73(1) rollover generally means that the property is transferred at the transferor's tax cost, with no taxation at the time of transfer. This means that the transferred property will be recorded at the adjusted cost base value for non-depreciable assets and at the UCC for depreciable assets. Given this, it seems logical that any capital gain or recaptured CCA from a subsequent sale by the spouse would be measured from that tax cost and attributed back to the transferor. This approach is, in fact, required under ITA 74.2.
>
> **Transfers To A Related Minor - General Rule** There is no general rollover provision for related minors that corresponds to ITA 73(1) for a spouse or common-law partner. This means that when property is transferred to a related minor, the transfer will normally take place at the fair market value of the property, resulting in the transferor recognizing any capital gains or recaptured CCA that have accrued to the time of transfer. Reflecting this fact, any gain on a subsequent sale by the related minor would be measured using the fair market value at the time of transfer. Further, such gains are not attributed back to the transferor, but are taxed in the hands of the related minor.
>
> **Transfers To A Minor Child - Farming Or Fishing Property** As discussed in this Chapter at Paragraph 9-173, ITA 73(3.1) and ITA 73(4.1) provide for a transfer of farm or fishing property to a child at its tax cost. It is not surprising that, when this rollover provision is used, there is attribution of gains arising on a subsequent disposition by the child. More specifically, ITA 75.1 indicates that when a farm or fishing property has been transferred to a child on a rollover basis and the child disposes of that property prior to reaching the age of 18 years, all capital gains and capital losses, both those existing at the time of transfer and those accruing subsequently, are attributed back to the transferor and taxed in the transferor's hands.

## Not Applicable After Death Of Transferor

9-196. Income attribution ceases with the death of the transferor. For example, if a parent made an inter vivos transfer to a minor child, income on the transferred asset would be attributed back to the transferor until the minor reached the age of 18. However, if the transferor died before the minor was 18, attribution of this income would cease on the date of the death.

**Figure 9 - 3**
**Attribution By Type Of Income**




### Not Applicable To Business Income

9-197. Business income is not subject to the attribution rules. If the assets that are transferred to a spouse, common-law partner, or related minor, are used to produce business income, this type of income will be taxed in the hands of the transferee. The logic of this seems clear. In order to earn business income, an effort is required on the part of the transferee. This means that the resulting business income is not a simple gift, but something that has to be earned. In these circumstances, it would not seem equitable to attribute these amounts to the transferor who provided the property.

9-198. Note, however, that if a business is transferred to a spouse or common-law partner, any capital gain on a subsequent sale of the business assets will be attributed back to the transferor, despite the fact that business income earned between the transfer and the sale will not be attributed to the transferor.

### Not Applicable If Subject To Tax On Split Income

9-199. A further exception to the income attribution rules is income that is subject to the tax on split income. While this tax is discussed in detail in Chapter 11, we would note here that this is a special tax on certain types of income that is sourced from related parties. This special tax is assessed at the maximum federal rate of 33 percent, beginning with the first dollar of such income received.

9-200. With income subject to the tax on split income being taxed at the maximum federal rate of 33 percent, any potential income splitting advantage has been eliminated. As a consequence, there is really no point in applying the income attribution rules to income that is subject to this tax. This view is reflected in ITA 74.5(13) which indicates that the income attribution rules in ITA 74.1(2) are not applicable to income that is subject to the tax on split income.

### Summary Of Rules

9-201. The attribution rules, classified by type of income, are summarized in Figure 9-3.

## Avoiding Income Attribution

9-202. The basic idea behind the income attribution rules is to restrict an individual's ability to simply give a source of income to a related individual for income splitting purposes. The procedure for avoiding these rules on a transfer to a related minor is straightforward:

**Transfers To A Related Minor** In this case, ITA 74.5(1)(a) indicates that the income attribution rules are not applicable if the related minor provides, from his own resources, consideration equal to the fair market value of the asset transferred. ITA 74.5(1)(b) indicates that, if such consideration includes debt payable by the related minor, it is acceptable only if it requires interest based on at least the prescribed rate at the time of the transfer.

9-203. The ITA 73(1) rollover (see inter vivos spousal transfers beginning in Paragraph 9-160) complicates the avoidance of the income attribution rules on transfers to a spouse:

**Transfers To A Spouse - ITA 73(1) Applicable** If a property is transferred to a spouse without electing out of the ITA 73(1) rollover, income attribution will always be applicable. Without regard to any amount of consideration provided by the transferee, the proceeds of disposition to the transferor will be the adjusted cost base of the transferred non-depreciable property, or the UCC of the depreciable property. These values will also be used for the adjusted cost base or UCC for the transferee. We would remind you that the transferee will retain the transferor's capital cost for purposes of determining capital gains and recapture.

**Transfers To A Spouse - Electing Out Of ITA 73(1)** There are two possible cases here:

**Consideration Equal To Fair Market Value** If the transferee provides consideration equal to the fair market value of the property that is transferred, the income attribution rules will not apply. As noted previously, ITA 74.5(1)(b) indicates that, if such consideration includes debt payable by the related spouse, it is acceptable only if it requires interest based on at least the prescribed rate at the time of the transfer.

The proceeds of disposition to the transferor will be equal to the fair market value of the property transferred. The adjusted cost base or capital cost of the property to the transferee will also be the fair market value of the property transferred. However, the UCC will be equal to the transferor's UCC, plus one-half the difference between this value and the fair market value (see text beginning in Paragraph 9-168).

**Consideration Not Equal To Fair Market Value** If the consideration provided by the transferee is more or less than fair market, or if there is no consideration given, the rules of ITA 69 become applicable for determining the proceeds of disposition to the transferor and the tax values for the transferee. If the consideration is either nil or less than fair market value, the income attribution rules will be applicable. If the consideration is more than fair market value, ITA 69 will deem the proceeds to be equal to fair market value and, in this case, the income attribution rules will not be applicable.

**Summary - Transfers To A Spouse** With respect to avoiding income attribution on transfers to a spouse, the income attribution rules will apply unless:

- The transferor elects out of the ITA 73(1) rollover; and
- The transferee provides consideration equal to or greater than fair market value.

## *Example*

9-204. The following example will illustrate the provisions that we have just discussed.

**EXAMPLE** Mrs. Blaine owns a group of equity securities with an adjusted cost base of $200,000. On December 31, 2018, the fair market value of these securities is $300,000. On this date, she gives one-half of the securities to her unemployed husband Mark, and the other one-half to her 5 year old daughter Belinda.

Both Mark and Belinda hold the securities until December 31, 2019, at which point they are sold for a total of $350,000 ($175,000 each). During 2019, the securities paid $37,500 in eligible dividends ($18,750 to both Mark and Belinda).

**ANALYSIS - Transfer To Spouse** Assuming that Mrs. Blaine has not elected out of the ITA 73(1) rules, the transfer to her husband would take place at the adjusted cost base of $100,000 [(1/2)($200,000)] and she would not record a 2018 gain. However, the adjusted cost base of the shares to Mark would be Mrs. Blaine's adjusted cost base of $100,000.

This means that when Mark sells the shares, the taxable capital gain will be $37,500 [(1/2)($175,000 - $100,000)], all of which will be attributed to Mrs. Blaine in 2019. In addition, the $18,750 in dividends received by Mark in 2019 would also be attributed to Mrs. Blaine. The taxable amount would be $25,875 [(138%)($18,750)] and Mrs. Blaine would get the related dividend tax credit.

**ANALYSIS - Transfer To Minor** As indicated previously, the rules for minors are somewhat different. As there is no general rollover provision for minor children in this case, the gift to Belinda would be treated as a disposition at fair market value, resulting in a 2018 taxable capital gain for Mrs. Blaine of $25,000 [(1/2)($150,000 - $100,000)]. Belinda's adjusted cost base for the shares would then be $150,000. When the shares are sold by Belinda, the additional taxable capital gain of $12,500 [(1/2)($175,000 - $150,000)] would be taxed in Belinda's hands and would not be attributed to Mrs. Blaine.

The treatment of the dividends for Belinda is the same as for Mr. Blaine, resulting in an additional $18,750 in dividends being attributed to Mrs. Blaine for 2019. The taxable amount would be $25,875 [(138%)($18,750)] and Mrs. Blaine would get the related dividend tax credit.

9-205. If either Mark or Belinda reinvests the proceeds from selling the shares, dividend or interest income resulting from the reinvestment will also be attributed back to Mrs. Blaine. Any capital gains on the new investments that are realized by Mark will also be attributed to Mrs. Blaine. This will not be the case with capital gains realized by Belinda. Note, however, that the compound earnings resulting from the reinvestment of the dividends received from the new investment are not subject to the attribution rules.

## Exercise Nine - 15

**Subject:** Income Attribution From A Spouse

On December 31, 2018, Mrs. Norah Moreau gives shares with an adjusted cost base of $23,000 and a fair market value of $37,000 to her husband, Nick Moreau. On February 24, 2019, the shares pay eligible dividends of $2,500 ($3,450 taxable amount) and, on August 31, 2019, Mr. Moreau sells the shares for $42,000. Assume that Mrs. Moreau does not elect out of ITA 73(1). What are the tax consequences for Mr. Moreau and Mrs. Moreau, in each of the years 2018 and 2019? If there are no tax consequences for either individual in a given year, you should clearly state this fact in your answer.

## Exercise Nine - 16

**Subject:** Income Attribution From A Related Minor

On December 31, 2018, Mrs. Norah Moreau gives shares with an adjusted cost base of $23,000 and a fair market value of $37,000 to her 12 year old daughter, Nicki Moreau. On February 24, 2019, the shares pay eligible dividends of $2,500 ($3,450 taxable amount) and, on August 31, 2019, Nicki sells the shares for $42,000. What are the tax consequences for Mrs. Moreau and Nicki in each of the years 2018 and 2019?

**SOLUTIONS available in print and online Study**

## Exercise Nine - 17

**Subject:** Income Attribution - Use Of Loans

On December 31, 2018, Mr. Nadeem Bronski gives corporate bonds to his wife in exchange for a note with a face value of $121,000. The corporate bonds have an adjusted cost base of $115,000 and a fair market value of $121,000. The note from his wife does not pay interest and has no specific maturity date. Mr. Bronski does not report a gain on these bonds in 2018.

During 2019, the bonds pay interest to Mrs. Bronski in the amount of $6,100. On October 1, 2019, immediately after an interest payment, Mrs. Bronski sells the bonds for $129,000. She uses $121,000 of the proceeds to pay off the loan owing to her husband. What are the tax consequences for Mr. and Mrs. Bronski in each of the years 2018 and 2019?

**SOLUTION available in print and online Study Guide.**

## Income Attribution - Other Related Parties

9-206. The applicability of the income attribution rules that were previously discussed is limited to transfers and loans to spouses and related individuals under the age of 18. There is another income attribution provision that applies to a broader group of individuals. This is found in ITA 56(4.1) and indicates that, if an interest free or low rate loan is made to a related party for the purpose of producing property income, the income can be attributed back to the individual making the loan. A further condition for this attribution is that one of the main reasons for making the loan is to reduce or avoid tax.

9-207. The most important application of this provision is to loans made by parents to their adult children. For children 18 or over, the general income attribution rules do not apply. Although there are no tax consequences associated with cash gifts to adult children, parents interested in providing some financial assistance to their children can be reluctant to completely lose control over the resources involved.

9-208. As an example, a parent might extend an interest free loan to an adult child to assist with the purchase of a property. If the child decides to live in the property, there is no attribution related to the interest free loan used to purchase the principal residence. However, if the child uses the property to produce rental income, this income can potentially be attributed back to the parent making the loan.

9-209. The tax planning conclusion in this situation is obvious. If a parent wishes to provide financial assistance to an adult child to earn property income, the appropriate route is to use an outright gift. While an interest free loan can accomplish the goal of providing financial assistance to the child, ITA 56(4.1) can eliminate the potential tax savings associated with this form of income splitting.

**We suggest you work Self Study Problems Nine-10 and Nine-11 at this point.**

## Anti-Avoidance Provisions

9-210. Given the attractiveness of income splitting, it is not surprising that tax planners have shown considerable ingenuity in devising procedures to avoid these attribution rules. It is equally unsurprising that the federal government has continued to come up with new rules to deal with these procedures.

9-211. Current legislation contains a number of provisions directed at preventing the use of indirect transfers, corporations, or trusts to circumvent the attribution rules. Complete coverage of these anti-avoidance rules is beyond the scope of this material. However, some of the more important anti-avoidance rules can be described as follows:

- ITA 74.1(3) prevents the substitution of a new low rate or interest free loan for an existing commercial rate loan.
- ITA 74.5(6) prevents a loan from being made to a person who is not subject to the attribution rules, who then makes a similar loan to a person who would be subject to the attribution rules if the loan had been directly made to that individual. The use of the intermediary would be disregarded and indirect attribution would apply.
- ITA 74.5(7) prevents the use of loan guarantees to avoid the attribution rules. That is, a higher income spouse cannot get around the attribution rules by providing a guarantee on a low rate or interest free loan to a spouse that is made by a third party.
- ITA 74.3 and 74.4 contain a variety of rules designed to prevent the avoidance of the attribution rules through the use of a trust (ITA 74.3) or a corporation (ITA 74.4).

## Tax Planning And Income Attribution

9-212. In recent years it has become increasingly difficult to avoid the income attribution rules. Further, many of the plans that are available for this purpose involve corporations and trusts and are too complex to be dealt with in detail in an introductory level text such as this. However, there are a number of relatively simple points that can be helpful:

**Split Pension Income** As discussed in this Chapter, it is possible to transfer up to 50 percent of qualified pension income to a lower income spouse. This is an important provision which can provide for a significant reduction in family unit taxes.

**TFSAs** As discussed in this Chapter, Tax Free Savings Accounts can be used for income splitting as these plans are not subject to the income attribution rules.

**RESPs** As discussed in this Chapter, Registered Education Savings Plans can be used for a limited amount of income splitting.

**Spousal RRSPs** As is discussed in Chapter 10, the spousal Registered Retirement Savings Plan is a readily available device for a limited amount of income splitting.

**Assets With Capital Gains Potential** As there is no attribution of capital gains on transfers to related minors, assets with capital gains potential should be given to children, rather than to a spouse.

**Loans** The prescribed rate is currently 2 percent (2nd quarter of 2019). With the rate at this level, it is possible to find safe investments that have a higher yield. Given this, it may be useful to loan funds at this prescribed rate to a low income family member who reinvests the funds at a rate higher than 2 percent.

**Segregating Gifts To Spouses And Minors** If a spouse or minor child receives a gift or inheritance from a source to which attribution would not apply, the funds should be segregated for investment purposes and, if possible, should not be used for such non-deductible purposes as vacations, reducing the mortgage on the family home, or purchases of personal effects.

**Detailed Records** In order to have low income family members acquire investment income, it is necessary for them to have funds to invest. Having the higher income spouse pay for non-deductible expenditures such as household expenses, clothing, vacations, and the lower income spouse's income tax liability can help provide for this. Although tuition fees can be eligible for a tax credit (see Chapter 4), they do not have to be paid by the student to be eligible for the credit. It may be desirable to maintain separate bank accounts and relatively detailed records to ensure that it is clear that the lower income family members' funds are being used for investment purposes.

**New Businesses** When a new business is started, low income family members should be allowed to acquire an equity position, particularly if the capital requirements are small. Note, however, if the business experiences losses in its first years of operation, this may not be the best alternative.

**Salaries To Family Members** When business income is earned in the family unit, or through a related corporation, the lower income spouse and any children should be paid reasonable salaries for any activity that can be justified as business related. Examples would include bookkeeping, filing, and other administrative work.

**We suggest you work Self Study Problems Nine-12 and Nine-13 at this point.**

**Additional Supplementary Self Study Problems Are Available Online.**

## Key Terms Used In This Chapter

9-213. The following is a list of the key terms used in this Chapter. These terms, and their meanings, are compiled in the Glossary located at the back of the Study Guide.

| | |
|---|---|
| Alimony | Eligible Child |
| Annual Child Care Expense Amount | Inadequate Consideration |
| Annuity | Income Attribution |
| Anti-Avoidance Provision | Income Splitting |
| Arm's Length | Inter Vivos Transfer |
| Canada Disability Savings Bonds | Moving Expenses |
| Canada Disability Savings Grants | Non-Arm's Length |
| Canada Education Savings Grants | Periodic Child Care Expense Amount |
| Canada Learning Bonds | Registered Disability Savings Plan (RDSP) |
| Child Care Expenses | Registered Education Savings Plan (RESP) |
| Child Support | Retiring Allowance |
| Common-Law Partner | Spousal Support |
| Death Benefit | Spouse |
| Deferred Income Plans | Support Amount |
| Disability Supports Deduction | Tax Free Savings Account (TFSA) |
| Earned Income (Child Care Expenses) | |

## References

9-214. For more detailed study of the material in this Chapter, we refer you to the following:

| | |
|---|---|
| ITA 56 | Amounts To Be Included In Income For Year |
| ITA 56.1 | Support |
| ITA 60 | Other Deductions |
| ITA 60.1 | Support |
| ITA 62 | Moving Expenses |
| ITA 63 | Child Care Expenses |
| ITA 64 | Disability Supports Deduction |
| ITA 74.1(1) | Transfers And Loans To Spouse Or Common-Law Partner |
| ITA 74.1(2) | Transfers And Loans To Minors |
| ITA 74.2 | Gain Or Loss Deemed That Of Lender Or Transferor |
| ITA 74.5 | Transfers For Fair Market Consideration |
| ITA 146.1 | Registered Education Savings Plans |
| ITA 146.2 | Tax-Free Savings Accounts |
| ITA 146.4 | Registered Disability Savings Plans |

| | |
|---|---|
| ITR 300 | Capital Element Of Annuity Payments |
| IC 93-3R2 | Registered Education Savings Plans |
| S1-F1-C3 | Disability Supports Deduction |
| S1-F2-C3 | Scholarships, Research Grants, And Other Education Assistance |
| S1-F3-C1 | Child Care Expense Deduction |
| S1-F3-C3 | Support Payments |
| S1-F3-C4 | Moving Expenses |
| S1-F5-C1 | Related Persons And Dealing At Arm's Length |
| S2-F1-C2 | Retiring Allowances |
| S3-F10-C1 | Qualified Investments - RRSPs, RESPs, RRIFs, RDSPs, and TFSAs |
| S3-F10-C2 | Prohibited Investments - RRSPs, RRIFs and TFSAs |
| S3-F10-C3 | Advantages - RRSPs, RESPs, RRIFs, RDSPs, And TFSAs |
| IT-209R | Inter Vivos Gifts Of Capital Property To Individuals Directly or Through Trusts |
| IT-325R2 | Property Transfers After Separation, Divorce And Annulment |
| IT-499R | Superannuation Or Pension Benefits |
| IT-508R | Death Benefits |
| IT-510 | Transfers And Loans Of Property Made After May 22, 1985 To A Related Minor |
| IT-511R | Interspousal And Certain Other Transfers And Loans Of Property |
| RC4092 | Registered Education Savings Plans |
| RC4460 | Registered Disability Savings Plan |
| RC4466 | Tax Free Savings Account |

# Problems For Self Study (Online)

To provide practice in problem solving, there are Self Study and Supplementary Self Study problems available on MyLab Accounting.

Within the text we have provided an indication of when it would be appropriate to work each Self Study problem. The detailed solutions for Self Study problems can be found in the print and online Study Guide.

We provide the Supplementary Self Study problems for those who would like additional practice in problem solving. The detailed solutions for the Supplementary Self Study problems are available online, not in the Study Guide.

The .PDF file "Self Study Problems for Volume 1" on MyLab contains the following for Chapter 9:

- 13 Self Study problems,
- 8 Supplementary Self Study problems, and
- detailed solutions for the Supplementary Self Study problems.

# Assignment Problems

(The solutions for these problems are only available in the solutions manual that has been provided to your instructor.)

## Assignment Problem Nine - 1

### (Death Benefits)

On December 15, 2019, Jasmine Li dies when the motorcycle she was driving hit a raccoon. She was 52 years old at the time of her death. She is survived only by her 23 year old son, Mark Li.

Jasmine had been a full time employee of Arboor Landscapers for many years. In recognition of her long time service, the business decides to pay her a death benefit of $12,000. It will be in annual instalments of $4,000 per year, beginning on December 31, 2019. The payments will be made to her son, Mark.

**Required:** What effect will this death benefit have on the Net Income For Tax Purposes of Mark Li and Ms. Li in 2019 and in subsequent years?

## Assignment Problem Nine - 2

### (Moving Expenses)

In May of the current year, following a dispute with her immediate superior, Ms. Elaine Fox resigned from her job in Halifax and began to look for other employment. She was not able to find acceptable work in Halifax, but she did locate her dream job in Regina and was expected to report for work on October 1.

After accepting the new job, Ms. Fox flew to Regina to find living quarters for herself. After two days of searching, she was able to locate a suitable house. Subsequent to purchasing her new home, Ms. Fox remained in Regina for an additional four days in order to purchase various furnishings for this residence. Her expenses for this trip were as follows:

| | |
|---|---|
| Air Fare (Halifax - Regina, Return) | $ 689 |
| Car Rental (6 Days At $35) | 210 |
| Hotel (6 Days At $150) | 900 |
| Food | 275 |
| Total Expenses | $2,074 |

On her return to Halifax, she received the following statements from her attorneys:

| | |
|---|---|
| Real Estate Commission - Sale Of Old Home | $ 9,500 |
| Legal Fees - Sale Of Old Home | 1,400 |
| Unpaid Taxes On Old Home To Date Of Sale | 800 |
| Legal Fees - Purchase Of New Home | 1,850 |
| Transfer Tax On New Home | 600 |
| Total | $14,150 |

On August 31 of the current year, after supervising the final packing of her property and its removal from the old house, Ms. Fox spent three days in a Halifax hotel while she finalized arrangements for her departure. Expenses during this period were as follows:

| | |
|---|---|
| Hotel (Three Days At $140) | $420 |
| Food | 145 |
| Total | $565 |

On September 3, she leaves Halifax by automobile, arriving in Regina on September 10. The distance traveled was 3,900 kilometers. As her new residence is not yet available, she is forced to continue living in a Regina hotel until September 26. Her expenses for the period September 3 through September 26 are as follows:

| | |
|---|---|
| Gasoline | $ 875 |
| Hotel (23 Days At $140) | 3,220 |
| Food | 975 |
| Total | $5,070 |

On moving into the new residence, she is required to pay the moving company a total of $3,800. This fee includes $675 for the 16 days of storage required because the new home was not available when the furnishings arrived.

Ms. Fox's only income for the current year was employment income and the net amounts to be included in her Net Income For Tax Purposes are as follows:

| | |
|---|---|
| Old Halifax Job (5 Months) | $32,000 |
| New Regina Job (3 Months) | 16,500 |
| Net Employment Income | $48,500 |

Ms. Fox will use the simplified method of determining vehicle and food costs in calculating her moving expenses. Assume that the relevant flat rate for vehicle expenses is $0.58 for all provinces, and the flat rate for meals is $51 per day.

Ms. Fox's new employer did not provide any reimbursement for moving expenses.

**Required:** Calculate the maximum allowable moving expenses that Ms. Fox can deduct from her Net Income For Tax Purposes for the current year and any amount that can be carried forward to a subsequent year.

### *Assignment Problem Nine - 3*

#### *(Child Care Expenses)*

Marco and Valentina Parker have been married 17 years. Unfortunately, during the first five months of 2019, Marco was unemployed. After much searching, he found employment as of June 1, 2019. His gross employment income for the remaining seven months of 2019 was $42,000. In addition, for the 2019 taxation year, he had interest income of $4,000 and received eligible dividends from public companies of $56,000.

Valentina was employed throughout 2019, earning gross employment income of $81,000. RPP contributions of $3,800 were withheld by her employer. She had no other source of income and during 2019.

In an effort to improve her management skills, Valentina attended a human resources course at a local university. The course lasted 14 weeks and required her to spend about 22 hours per week in classes and pairing assignments

As both Marco and Valentina had busy schedules, the couple incurred well documented child care costs of $17,500 (50 weeks at $350 per week).

**Required**: Determine the maximum amount that can be deducted by Mr. and Mrs. Parker for the year ending December 31, 2019 for child care expenses under the following assumptions:

A. They have three children, none of whom qualify for the ITA 118.3 disability tax credit. Their ages are 1, 3, and 4 years old.

B. They have four children, none of whom qualify for the ITA 118.3 disability tax credit. Their ages are 3, 5, 9, and 12 years old.

### *Assignment Problem Nine - 4*
#### *(Pension Income Splitting - With OAS)*

Felipe and Martina Gomez are both 66 years old. They are both in good health and have been married for over 30 years.

Over the years, Martina has accumulated a portfolio of dividend paying stocks. During 2019, these stocks paid eligible dividends of $35,000. Her only other source of 2019 income was OAS payments totaling $7,400.

Felipe had 2019 net rental income of $25,000. In addition, he made a 2019 withdrawal from his Registered Retirement Income Fund (RRIF) of $84,000. Other than OAS payments described in Alternative 2, Felipe had no other income during 2019.

They are considering splitting Felipe's RRIF withdrawal and have come to you for advice. To assist in deciding whether or not they should use this election they have asked you to provide information under each of two alternatives:

**Alternative 1** Their tax returns are prepared without splitting income. Felipe does not apply for OAS payments as they thought they would be totally clawed back due to his ongoing high level of income.

**Alternative 2** Their tax returns are prepared using the pension income splitting election. Felipe's pension income is evenly split, with $42,000 going to each spouse. Felipe applied for OAS at the beginning of the year and received OAS payments of $7,400 during the year.

They have no deductions that will be used in the determination of Taxable Income. Their combined 2019 medical expenses total $18,700 and they will be claimed by Felipe under each of the two alternatives.

Neither Felipe nor Martina are eligible for any tax credits other than the:

- basic personal credit,
- age credit,
- dividend tax credit,
- pension income credit, and
- medical expenses tax credit.

**Required:**

A. Calculate the amount of Net Income For Tax Purposes and Taxable Income for both Felipe and Martina under each of the two alternatives.

B. Based on your figures from Part A, calculate the amount owing to the CRA for both Felipe and Martina under each of the two alternatives. Provide a comparison of the amounts owing under the two alternatives.

C. Comment on the advantage/disadvantage of having the lower income spouse claim the medical expenses in both alternatives.

### Assignment Problem Nine - 5

#### (Other Income And Deductions Including RESP)

Viva Houde's divorce settlement resulted in her having custody of her two children. Her daughter Lacy is 8 years old and her son Mark is 10 years old. They are both in good health. The agreement calls for her to receive child support payments of $2,000 per month, as well as spousal support of $1,500 per month. During 2019, she received all of these payments.

In order to get a fresh start in life, she enrolled in a co-op program at Western University in London, Ontario. She was very successful during the winter term (January through April, 2019). The program requires her to work in her field during the summer, with her first placement being Timmins, Ontario during the period May to August, 2019. Her employment income for this period was $8,000.

In late August she returned to London and resumed full time studies during the fall term (September through December, 2019). She was also able to obtain a part time job in her field in London. During these four months she had employment income of $1,600.

The eligible moving costs associated with moving herself and her children to Timmins for the summer work term totaled $1,200. The costs for the move back to London were $1,350.

In addition to her support payments and employment income, Viva received the following amounts:

| | |
|---|---|
| Scholarship Granted By University For The Fall Semester | 4,300 |
| Eligible Dividends Received | 2,600 |
| Inheritance From Rich Uncle | 22,000 |
| TFSA Withdrawal | 4,000 |

Throughout the year, Viva required assistance with her children. During the period January through April, the costs in London totaled $1,950. In Timmins, she incurred costs of $1,725. After returning to London for the fall term, her costs for the September through December period were $2,175.

During 2019, Viva establishes RESPs for both of her children. She contributes $1,500 to each of these plans.

**Required:** Determine the minimum Net Income For Tax Purposes that Viva will report for the 2019 taxation year. Provide reasons for omitting items that you have not included in your calculations. Also, indicate any amounts that can be carried forward to future years.

### Assignment Problem Nine - 6

#### (Non-Arm's Length Transfer Of Shares)

Ms. Jody Wales owns shares in a Canadian public company that she acquired several years ago at a cost of $220,000. The shares have a current fair market value of $426,000. Ms. Wales and her husband, Jim, have three children. Their daughter Kim is 20 years old, while their sons Jeff and Jerry are respectively 22 and 24 years old.

On November 1 of the current year, Ms. Wales is considering the following alternatives for disposing of the securities:

A. Selling the shares to her daughter for $220,000.

B. Gifting the shares to her older son, Jerry.

C. Selling the shares to her younger son, Jeff, for $500,000.

**Required:** Indicate the immediate tax consequences to Ms. Wales that will result from making each of the transfers described. In addition, indicate the adjusted cost base of the shares to the transferee.

### *Assignment Problem Nine - 7*

#### *(Non-Arm's Length Transfer Of Depreciable Asset)*

During 2019, Joan Zelig sells three depreciable assets. In each case, the asset that is sold is the last one in its class.

> **Asset 1** has a capital cost of $150,000 and, at January 1, 2019, the UCC balance in its class is $103,883. The asset is sold to Joan's sister for its fair market value of $115,000.
>
> **Asset 2** has a capital cost of $140,000 and, at January 1, 2019, the UCC balance in its class was $58,310. The asset is sold to Joan's father for its fair market value of $35,000.
>
> **Asset 3** has a capital cost of $95,000 and, at January 1, 2019, the UCC balance in its class was $82,369. The asset is sold to Joan's mother for its fair market value of $107,000.

**Required:** For each of the three dispositions, indicate the tax consequences for Joan that result from the sale. In addition, indicate the tax values that will be used by the transferee subsequent to the transfer.

### *Assignment Problem Nine - 8*

#### *(Deemed Dispositions On Death And Emigration)*

Mr. Howard Caswell is 67 years of age and his spouse, Charlene, is 58. They have one son, John, who is 36 years of age.

On September 1 of the current year, Mr. Howard Caswell owns the following properties:

> **Rental Property** Mr. Caswell owns a rental building that was acquired at a cost of $120,000. This includes an estimated value for the land on which the building is situated of $25,000. On September 1 of the current year, the building's UCC is $67,000. As of this date, the fair market value of the property has increased to $158,000, including an unchanged value for the land of $25,000.
>
> **General Industries Ltd**. Mr. Caswell owns 5,000 shares of General Industries Ltd., a Canadian public company. These shares have a cost of $200,000 and a current fair market value of $350,000. Mr. Caswell has never owned more than 3 percent of the outstanding shares of this Company.
>
> **Farm Land** Mr. Caswell owns farm land with a cost of $325,000 and a current fair market value of $550,000. The land is farmed on a full time basis by Mr. Caswell's son, John.
>
> **Caswell Enterprises** Mr. Caswell owns 100 percent of the voting shares of Caswell Enterprises, a Canadian controlled private corporation. The Company was established with an investment of $275,000 and it is estimated that the current fair market value of the shares is $426,000. Caswell Enterprises is not a qualified small business corporation for purposes of the lifetime capital gains deduction.

Assume that no elections are made and that normal deemed disposition values apply.

**Required:** Explain the tax consequences that would result in each of the following Cases for Mr. Caswell for the current year. In your solutions for Cases A and B, include the tax base of the assets to the transferee.

A. Mr. Caswell dies on September 1 of the current year, leaving all of his property to his spouse, Charlene.

B. Mr. Caswell dies on September 1 of the current year, leaving all of his property to his son, John.

C. Mr. Caswell departs from Canada and ceases to be a resident on September 1 of the current year (covered in Chapter 8).

### *Assignment Problem Nine - 9*

### *(Transfers To A Spouse - Income Attribution)*

Jason Holt has owned a number of rental properties for many years. He has been married to Geena Holt for 5 years. Their pre-nuptial agreement requires Jason to gift a rental property to Geena on each 5th anniversary of their marriage.

On January 1, 2019, as required by their pre-nuptial agreement, Jason gifts one of the rental properties to Geena. Information on this property is as follows:

| | Land | Building |
|---|---|---|
| Original Cost | $123,000 | $387,000 |
| Fair Market Value - Date Of Transfer | 167,000 | 426,000 |
| UCC - Date Of Transfer | N/A | 299,772 |

During 2019, the property had a net rental income, before the deduction of CCA, of $23,451. Geena plans to deduct maximum CCA.

On January 1, 2020, after concluding that other investments would provide a better return, Geena sells the rental property for $650,000. At this time, an appraisal indicates that the fair market value of the land has increased to $175,000, leaving $475,000 ($650,000 - $175,000) to be allocated to the building.

**Required:** Determine the tax effects associated with the transfer and subsequent sale of the property for both Mr. and Mrs. Holt assuming:

A. The facts are as stated in the problem and that Mr. Holt does not elect out of ITA 73(1).

B. The pre-nuptial agreement requires that Geena purchase the property for its fair market value, using her own funds. On this sale, Mr. Holt elects out of ITA 73(1).

### *Assignment Problem Nine - 10*

### *(Gifts And Income Attribution)*

Ms. Vicky Vaughn is a very successful attorney with an income of over $500,000 per year. She is married to Mr. Jonathan Flex, a former Mr. Canada. Mr. Flex has no income of his own.

She and Mr. Flex have two children. Their daughter Sheila is 27, while their son Biff is 15. To date, Ms. Vaughn has not gifted or sold property to either her spouse or to her children.

At the end of the current year, Ms. Vaughn owns the following assets:

> **Shares Of TD Bank** Ms. Vaughn owns 10,000 shares with a current fair market value of $700,000. The adjusted cost base for these shares is $550,000.
>
> **Vaughn Enterprises Ltd.** Ms. Vaughn owns all of the shares of this Canadian controlled private company. Her adjusted cost base for these shares is $475,000. A business valuator has concluded that the shares are currently worth $1,200,000. Vaughn Enterprises is not a qualified small business corporation for purposes of the lifetime capital gains deduction.

**Rental Property** Ms. Vaughn owns a 22 unit apartment building with a current fair market value of $2,400,000. It is estimated that $400,000 of this value is associated with the land. Ms. Vaughn purchased the unit several years ago at a total cost of $1,500,000, with $300,000 of this value associated with the land. As of January 1 of the current year, the UCC of the Class 1 building is $960,000.

**Farm Land** Ms. Vaughn owns farm land that cost $800,000 and has a current fair market value of $1,200,000. Sheila uses the farm land on a full time basis to grow certified organic vegetables.

As Ms. Vaughn's income is more than sufficient for her needs, she is considering giving all or part of the properties to her spouse and/or her two children.

**Required:** You have been hired as a tax consultant to Ms. Vaughn. She would like a report that would detail, for each of the four properties, the tax consequences to her of making a gift of the item to her husband or to either one of her children. In determining the required tax consequences, ignore the possibility that the Tax On Split Income (TOSI) may be applicable to any of the income realized on the properties.

Ms. Vaughn does not elect out of ITA 73(1) if the gifts are made to Mr. Flex. In addition, assume that the recipient of the rental property does not take CCA prior to the subsequent sale of the property.

Your report should include:

- the tax consequences to Ms. Vaughn at the time of the gift;
- the tax cost of the properties to the recipient of the gift;
- the tax treatment of any income on the property subsequent to the gift and before the property is sold; and
- the tax consequences that would result from a subsequent sale of the gifted property at $100,000 more than its fair market value at the time of the gift. In the case of the rental property, assume that all of this extra $100,000 can be allocated to the building, with no change in the value of the land.

## *Assignment Problem Nine - 11*

### *(Gifts And Income Attribution)*

Valerie Nixon is a partner in a national CPA firm. Her income normally exceeds $350,000. She is married to Bunny Blake, a former Ms. World contestant.

Valerie and Bunny have two adopted children. Their son, Richard is 14 years old while their daughter, Patricia is 19 years old. To this point in time, Valerie has not gifted or sold property to any of the members of her immediate family.

With her high level of income, Valerie has accumulated a significant amount of investment assets. Her current portfolio contains the following items:

- Shares in a Canadian controlled private company, **Nixon Distributors**. Valerie is the only shareholder of this Company, an enterprise she started several years ago with an investment of $823,000. It is estimated that the shares are currently worth $1,800,000. Nixon Distributors is not a qualified small business corporation for purposes of the lifetime capital gains deduction.

- Shares of **Royal Bank**. The 15,000 shares that she holds have an adjusted cost base of $1,050,000. Their current fair market value is $1,230,000.

- As she grew up in rural Ontario, Valerie has always had a love of farming. This is reflected in a holding of **Farm Land** that she acquired several years ago for $650,000. It is estimated that the current fair market value of this land is $960,000. Bunny operates the farm on a full time basis to grow organic vegetables.

- A 10 unit residential **Rental Property** that she purchased for $1,300,000. At the time of the purchase, the value of the land was estimated to be $400,000. At January 1 of the current year, the UCC of the property was $749,124. A recent appraisal indicates that the fair market value of the land has increased to $600,000 and the fair market value of the building has increased to $1,300,000.

Valerie has been diagnosed with terminal cancer, with her doctor indicating that she has less than two years to live. Given this, she would like to begin gifting her properties to Bunny, Richard, and Patricia. In the case of gifts to Bunny, she will not elect out of ITA 73(1).

Assume the recipient of the gift sells the property prior to Valerie's death.

**Required:** For each of the four listed properties, provide the following information. In determining the required tax consequences, ignore the possibility that the Tax On Split Income (TOSI) may be applicable to any of the income realized on the properties.

Your answer should include the different results related to the three possible gift recipients.

1. The tax consequences to Valerie at the time of the gift.
2. The tax cost of the properties to the recipient of the gift.
3. The tax treatment of any income on the property subsequent to the gift and before the property is sold.
4. The tax consequences that would result from a subsequent sale of the gifted property, (prior to Valerie's death), at a price that is $100,000 more than the fair market value at the time of the gift. In the case of the rental property, assume that the extra $100,000 is allocated to the building, with no change in the value of the land. Also in the case of the rental property, assume that the recipient of the gift does not deduct CCA prior to the sale.

## *Assignment Problem Nine - 12*

### *(Comprehensive Case Covering Chapters 1 to 9)*

### *Family Information*

Spencer James is 41 years old. He has been married to Suzanne James for over 20 years. The couple have three children. All members of the family are in good health. Information on the children is as follows:

**Charles And Charlene** are 8 year old twins. During 2019, each of the twins received eligible dividends of $1,000 on public company shares that were gifted to them by their father in July, 2018. At the time of the gift, each block of shares had a fair market value of $9,500. Spencer had acquired the two blocks of shares at a cost of $8,000 each. In December, 2019, each twin sold the shares for $10,000.

**Charlton** is 19 years old and attends university on a full time basis for 4 months of the year. Spencer and Suzanne pay his tuition fees of $6,300, along with textbook costs of $650. He has agreed to transfer the maximum amount of his tuition credit to his father. Charlton lives with Spencer and Suzanne. His only income for the year is from the sale of shares purchased from Spencer as described in the following text.

In June, 2019, Spencer sells shares with an adjusted cost base of $28,000 and a fair market value of $36,500 to his son, Charlton. In order to provide Charlton with money to buy a car and to create a capital loss for himself, he sells the shares to Charlton for $5,000. Charlton sells the shares in September for $42,000.

Because of their work demands, Spencer and Suzanne have child care costs for the two twins of $250 per week for 48 weeks. During the remaining 4 weeks, the twins are sent to summer camp at a cost of $250 per child per week.

### *Suzanne's Income Information*

Suzanne operates a mail order business out of rented space. As it is furnished business space,

the business does not own any capital assets. For 2019, her net business income, calculated on the basis of tax rules was $70,544.

During 2019, Suzanne spent 6 consecutive weeks attending a specialized business accounting program at a designated educational institution. She received a tuition tax receipt that stated she had paid $2,000 in tuition fees.

In January, 2018, Spencer gifted Suzanne a residential rental property. This property had cost Spencer $500,000 several years ago, with $100,000 of this amount allocated to the land and $400,000 allocated to the building. At the time of the gift, an appraisal indicates that the fair market value of the building was $530,000, allocated $110,000 to the land and $420,000 to the building. The building had a January 1, 2018 UCC of $376,320. Spencer did not recognize this transaction in his 2018 tax return.

For the year ending December 31, 2018, Suzanne had net rental income, after the deduction of maximum CCA, of $16,400.

In November, 2019, after experiencing significant difficulties with tenants, Suzanne lists the property for sale. It sells within a month for $555,000, with $120,000 of this total allocated to the land and $435,000 allocated to the building. The net rental income, prior to the deduction of CCA, was $15,300 for 2019.

### *Spencer's Employment Information*

Spencer is employed by a Canadian public company. His annual salary is $106,700, none of which is commissions. His employer withheld the following amounts from his remuneration:

| | |
|---|---|
| EI Premiums | $ 860 |
| CPP Contributions | 2,749 |
| Professional Association Dues | 1,200 |
| Registered Pension Plan Contributions | 4,200 |

Spencer's employer made a matching RPP contribution of $4,200.

Because of his excellent performance during 2019, Spencer was awarded a bonus of $20,000. Of this total, $10,000 will be paid in 2019, with the balance being paid in June, 2020.

Spencer is provided with an automobile by his employer. The vehicle is leased by the employer at a rate of $523 per month, including a payment of $51 per month for insurance. The automobile is available to Spencer for 11 months during 2019. During the remaining month, the employer required that it be returned to their garage. Total milage for 2019 is 58,000 kilometers, only 5,000 of which are for personal use.

On their birthday, Spencer's employer provides every employee with a $1,000 gift certificate that can be used for merchandise on Amazon. In addition, at Christmas, each employee receives a basket of gourmet food and wine. The value of this basket is $350.

During 2019, Spencer spent $5,600 on meals and entertainment of his employer's customers. The employer's policy is to reimburse 80 percent of these costs.

For the last ten years, Spencer has worked in a rural office of his employer. The rural office is located 110 kilometers from the Company's head office in a major Canadian city. As his family has become less enchanted with the country life style, Spencer has transferred to the Company's city office. The move involves selling his rural home and acquiring a city home. The various cash outflows associated with the move are as follows:

| | |
|---|---|
| Real Estate Commissions - Old Home | $11,620 |
| Legal Fees - Old Home | 1,250 |
| Loss - Old Home | 18,000 |
| Unpaid Property Taxes - Old Home | 625 |
| Cleaning And Minor Repairs - Old Home | 450 |
| Legal Fees - New Home | 1,460 |
| Cost Of Moving Household Goods | 3,460 |

While Spencer's employer does not provide a moving allowance, the company agrees to compensate him for his $18,000 loss on his old home as management expects him to spend the time he spent commuting at the office.

### *Other Information*

1. The family's medical expenses for 2019 were as follows:

| | |
|---|---:|
| Spencer | $ 4,600 |
| Suzanne* | 8,600 |
| Charles | 4,700 |
| Charlene | 3,600 |
| Total Medical Expenses | $21,500 |

   *This medical expense was for a brow lift to remove wrinkles and improve the appearance of Suzanne's forehead.

2. In January, 2019, Spencer's father dies. He was an unsuccessful pig farmer who agonized over the death of each pig. The major asset in his father's estate is a family farm operation which is left to Spencer (other assets go to Spencer's mother and siblings). Information on the farm's assets is as follows:

   **Land** The farm land had an adjusted cost base of $250,000. At the time of the father's death, the fair market value was $375,000.

   **Building** The building had a capital cost of $325,000, a fair market value at the time of the father's death of $275,000, and a UCC of $253,000.

   **Equipment** The equipment had a capital cost $130,000, a fair market value at the time of death of $110,000, and a UCC of $95,000.

   The executors of the father's estate elect to transfer the land at its fair market value in order to use up accumulated capital losses on other assets. The building and equipment are transferred at the UCC values.

3. As Spencer, and especially his family, have no interest in running a pig farm, he sells the inherited property to his brother in March, as soon as he has title. His brother agrees to purchase the assets for the fair market values determined by the executors, specifically $375,000 for the land, $275,000 for the building and $110,000 for the equipment.

4. In memory of his father, Spencer donates $8,400 on his father's birthday in 2019 to Hearts On Noses - A Mini Pig Sanctuary. This registered charity helps preserve the lives of injured, abused, abandoned and neglected pot bellied pigs.

5. During 2019, Spencer makes a $4,000 contribution to his Tax Free Savings Account and $5,000 to Suzanne's. He also makes a $2,000 contribution ($1,000 per child) to the family Registered Education Savings Plan established for Charles and Charlene.

**Required:**

A. Determine Suzanne's federal Tax Payable and her CPP liability for 2019. In calculating Suzanne's federal Tax Payable, assume that Spencer's Taxable Income exceeds $200,000.

B. Determine Spencer's federal Tax Payable for 2019.

In determining these amounts, ignore GST, PST and HST considerations.

### Assignment Problem Nine - 13

#### (Comprehensive Case Covering Chapters 1 to 9)

On January 2, 2019, the car Jonathan Blount was driving was hit by a tractor trailer. His two sons, Dirk aged 15 and Cole aged 13 were also in the car. In the crash, Cole suffered a broken leg, Dirk suffered a spinal cord injury and Jonathan suffered injuries so severe that he died in the ambulance on the way to the hospital.

Jonathan was the manager of a Regina family grocery store started by his grandfather. In his will, Jonathan named his wife, Maria as his executor and left his total estate to her.

Maria Blount was 53 years old. In addition to Dirk and Cole, she had two daughters, Elena aged 23 and Trish aged 17. Elena was enrolled in the Athabasca University accounting program.

After Jonathan's death, Maria decided to move her family to Calgary for a number of reasons. The rehabilitation services she needed for Dirk were available in a Calgary hospital, the air travel connections for her promotional activities were better from Calgary, and Maria's wealthy parents lived near Calgary.

Maria listed her Regina home for sale in February. She and Jonathan jointly purchased the house for $95,000 in 2001. They spent $67,000 in renovations over the years. The house was sold for $299,900. Real estate fees totalled $16,250. Legal fees associated with the sale were $750.

During March, Maria flew to Calgary, business class, at a cost of $1,800 return to locate a new residence for her and her family. During the four days that she was there, her food and lodging costs totalled $1,220. After returning home, she made an offer on a newly built property for $1.2 million. The offer was accepted on March 20.

Maria, her children and her dogs left Regina on March 29 in her SUV. They spent the night in Medicine Hat and arrived in Calgary on March 30. The trip was 812 kilometers. Assume the kilometer rate is $0.58 for both Alberta and Saskatchewan.

Maria's bill for the Medicine Hat hotel totalled $1,270 for four rooms (Dirk and Cole were willing to share a room), dinner and breakfast for her and her family.

Unfortunately, her new Calgary home was not available until April 2 and, as a consequence, she and her children stayed in a Calgary hotel from March 31 through April 2. This time Dirk and Cole were unwilling to share a room so the total lodging bill was $1,800. The rate included a breakfast buffet so complete that everyone skipped lunch, except the dogs. Maria's parents took them all out to dinner both nights they were staying at the hotel.

The cost for moving her household effects totalled $2,340. The unplanned additional cost of leaving them in storage until her Calgary home was ready totalled $150. The cost of shipping her sports car to Calgary was $575. Her legal fees associated with acquiring the Calgary home were $900.

#### Business Information

Maria was the author of a popular series of romance novels that had many devoted followers impatiently waiting for the next book. They featured glamourous and sexy vampire accountants working for Bloodsuckers LLP. For 2019, the details of her business were as follows:

| | |
|---|---|
| Book Royalties ($75,000 was paid in June, the remainder was paid in December) | $212,000 |
| Assistant's Fees (Note 1) | 36,000 |
| Research Purchases (Note 2) | 2,250 |
| Promotional Travel Costs (Note 3) | 14,850 |
| Business (100 percent) cell phone charges | 600 |
| Purchase of new office furniture | 8,400 |
| Purchase of new desktop and laptop equipment | 8,000 |
| Purchase of new iPad Pro | 1,800 |
| Office Supplies | 3,480 |

**Note 1** The fees were paid to Elena. She did the accounting for Maria's business. She also proofread the manuscripts and due to her keen interest in both accounting and vampire lore, suggested corrections and revisions.

**Note 2** Maria had been approached to write a movie or mini-series based on her books. In Calgary, Maria purchased DVDs of TV series and movies that included vampires and accountants to see what was available already. She and Elena viewed all of her purchases and made many notes for a pilot episode for a series titled Blood-suckers LLP. Because of lack of storage space she gave them all away to be sold at the local high school's fund raising sale.

**Note 3** Her publisher reimbursed her 100 percent for her travel costs. She was very popular at book fairs and book readings and her public appearances always resulted in a major increase in sales of her work.

At Elena's insistence, Maria's very old computer's hard disk was wiped clean and recycled along with all of her old computer peripherals. Her only UCC balance as at January 1, 2019 was $150 for Class 50. The capital cost of the Class 50 assets to be recycled totalled $2,700.

As she did her writing in Regina on the kitchen table and in bed, she did not deduct workspace in the home costs prior to April 1. Due to the increasing success and scope of her work, Maria decided that she and Elena needed to have dedicated office space in Calgary.

Maria's office occupied 22 percent of the total area of her Calgary home. Her 2019 home expenditures for April 2 to December 31 were as follows:

| | |
|---|---:|
| Mortgage interest | $24,000 |
| Utilities | 5,600 |
| Property taxes | 11,500 |
| House insurance | 1,600 |
| House repair costs | 2,800 |
| House cleaning | 3,100 |
| Home telephone land line | 750 |
| Home internet service (40 percent business use) | 960 |

As she does not wish to have to report any capital gain or recapture upon its eventual disposition, Maria will not claim CCA on the portion of her home that is used for her office.

### *Other Information*

1. In February, 2019, Maria was surprised to receive a $15,000 cheque from the grocery store where Jonathan had worked. She learned it was a death benefit.
2. In March, 2019, she received a $50,000 cheque from her sister, Teresa. She had raised it through a GoFundMe online campaign to help pay for Dirk's medical costs. Jonathan was a volunteer hockey coach who was well loved by the many children he had coached over the years and their parents. The donations came in from all over Canada.
3. Maria's mother, Betty Lou was diagnosed with terminal cancer. She and Maria's father had run a very successful real estate firm for over 25 years. On July 1, 2019, Betty Lou gifted 1,000 preferred shares to each of her grandchildren. The 4,000 shares had a total fair market value of $1,000,000. The shares paid quarterly eligible dividends of $4 per share in September and December. At the end of 2019 Betty Lou was under hospice care.
4. Child care costs were necessary for Cole when Maria was away promoting her books. They totalled $3,900 for 2019. In the summer, Cole spent four weeks in July at a hockey camp in Canmore. The fees at this camp were $1,000 per week. Trish spent the same four weeks at a music camp in July in Banff. The fees at this camp were $800 per week. Maria spent the four weeks on the road, promoting her work.

5. Maria's stock trading portfolio had a 21 percent growth for 2019. Before Jonathan's death they had separate discount broker accounts. They had different tolerances for risk with Jonathan invested in a low risk portfolio and Maria invested in a high risk one. At the time of his death, Jonathan's stocks had a total adjusted cost base of $378,000 and a fair market value of $401,000. They were transferred to Maria's account in compliance with his will. On the transfer date, they had a fair market value of $408,000.

6. In September, she sold every stock from Jonathan's estate for a total of $392,000. In addition, she sold shares in a cannabis company for $26,600 that she had purchased at a cost of $11,000. Prior to September, the inherited stocks paid eligible dividends of $12,600.

7. During 2019, Maria made a $6,000 contribution to her Tax Free Savings Account (TFSA) and a $6,000 contribution to Elena's TFSA. She also made a $6,000 contribution ($2,000 per minor child) to the family Registered Education Savings Plan.

8. After the accident, the doctors who operated on Dirk said he would likely never walk or regain the use of his arms. He took this as a challenge and vowed that he would play hockey again. He wanted continual physiotherapy to help him achieve this goal. Maria used $46,000 of the money received through the GoFundMe campaign to pay for physiotherapists. By the end of December, Dirk was encouraged that he had regained some feeling in his hands, but he could not move them by himself. A doctor attending him gave Maria a T2201, Disability Tax Credit Certificate.

9. Maria used the remaining $4,000 of the GoFundMe money to pay for grief counselling by psychiatrists for herself, Trish, Dirk and Cole. Elena paid for her own medical expenses. The family's medical expenses paid for by Maria for 2019 were as follows:

| | |
|---|---:|
| Maria | $ 2,600 |
| Trish | 2,800 |
| Dirk (Including $9,300 Attendant Care Costs) | 56,700 |
| Cole | 4,100 |
| Total Medical Expenses | $66,200 |

**Required:**

A. Determine Maria's federal Tax Payable and her CPP liability for 2019. Ignore GST, PST and HST considerations

B. Calculate the increase in 2019 Net Income For Tax Purposes arising from the eligible dividends received for each of the four children.

# CHAPTER 10

# Retirement Savings And Other Special Income Arrangements

## Planning For Retirement

### Introduction

10-1. Increasing life expectancies and lower birth rates are creating a situation in which the portion of the Canadian population that is of retirement age has been increasing, and will continue to do so. This, in turn, leads to the need to allocate a growing proportion of our society's resources to caring for this older segment of the population. There are enormous social and economic considerations resulting from this trend and, given the large and growing political clout of Canadian senior citizens, it is not a situation that the government can ignore.

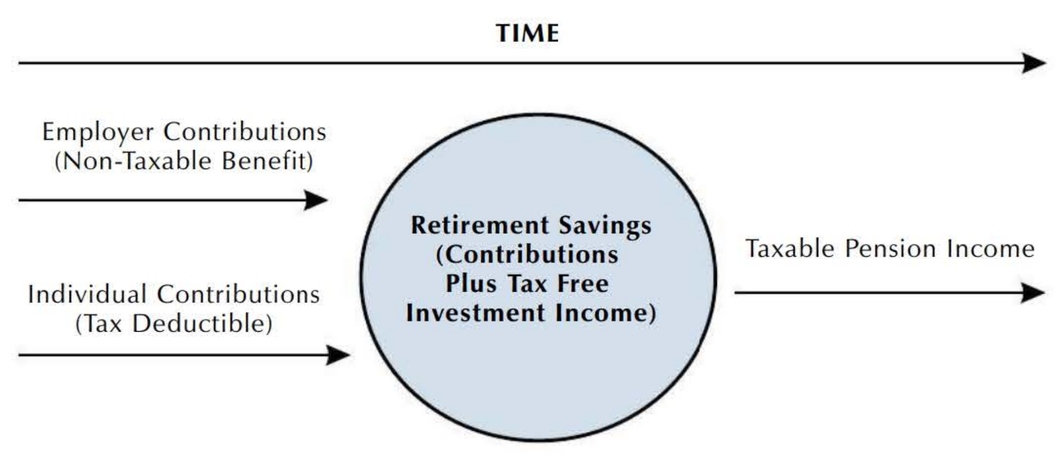
### Providing Consistency

10-2. Minimal financial requirements for the retirement years are provided by Old Age Security (OAS) payments and the Canada Pension Plan (CPP) system. However, for 2019, the maximum payment under the Canada Pension Plan is $13,900 per year for a person with no disability. When this is combined with the current OAS payments of about $7,400 per year, the total does not provide for the lifestyle most individuals would like to enjoy during their retirement years. In response to this situation, the Canadian income tax system contains a number of provisions that encourage the development of various private retirement savings arrangements to supplement benefits provided under the government provided plans. These include:

- Registered Retirement Savings Plans (RRSPs)
- Registered Pension Plans (RPPs), including Individual Pension Plans
- Target Benefit Plans
- Pooled Registered Pension Plans
- Registered Retirement Income Funds (RRIFs)
- Deferred Profit Sharing Plans (DPSPs)

10-3. The current retirement savings system was initiated in 1990. At the heart of this system is the concept that retirement savings should have an annual limit that is consistently applied to all types of plans. In general, this limit is defined in terms of an annual amount of contributions to a money purchase (a.k.a., defined contribution) Registered Pension Plan. The amount of this limit, designated the money purchase limit, is subject to annual indexing.

**Figure 10 - 1**
**Retirement Savings - The Basic System**




10-4. The major problem faced by the government in designing the current system was to ensure that, despite the variety of retirement savings vehicles available, the annual contribution limit was applied in a consistent manner, without regard to the variety of retirement savings vehicles used by an individual, or the manner in which the ultimate retirement benefit was determined.

10-5. The detailed provisions related to the different types of tax assisted retirement savings plans show considerable variation. For example, Registered Pension Plans and Deferred Profit Sharing Plans require employer sponsorship. In contrast, any Canadian resident can establish a Registered Retirement Savings Plan or a Registered Retirement Income Fund.

10-6. Despite such variations, the basic idea underlying all of these plans is the same. They allow individuals to invest a considerable amount of funds into a trusteed arrangement. The amounts invested are either deductible to the taxpayer (RRSP contributions and employee RPP contributions) or can be paid by an employer without creating a taxable benefit (employer RPP and DPSP contributions). Inside the trusteed arrangement, the invested funds can earn income on a tax free basis for long periods of time. While all amounts will ultimately be subject to taxation, there is a substantial amount of tax deferral. This arrangement can be seen graphically in Figure 10-1.

10-7. You will recall that we also discussed registered savings plans in Chapter 9. The discussion in that Chapter covered Tax Free Savings Accounts (TFSAs), Registered Education Savings Plans (RESPs) and Registered Disability Savings Plans (RDSP). There is a major difference between those plans and the ones that are under consideration here. The contributions made to TFSAs, RESPs and RDSPs are not deductible. In contrast, the retirement savings plans covered in this chapter provide tax advantaged contribution arrangements. Contributions made by beneficiaries are tax deductible and contributions made by employers are not treated as taxable benefits. We would remind you that employer contributions to RPPs and DPSPs can be deducted when made by the employer.

## Tax Deferred Savings

### *Sources Of Deferral*

10-8. As shown in Figure 10-1, there are two basic sources for the investment funds going into retirement savings plans. First, for employed individuals, employers may make contributions to RPPs and DPSPs. As these contributions do not create a taxable benefit until they are withdrawn as retirement income, the employee has received a benefit on which the payment

of tax has been deferred, despite the fact that the employer has an immediate deduction.

10-9. The second source of investment funds is the contributions made by employed individuals to RPPs, and by all individuals to RRSPs. As the individual can deduct these contributions against all types of income, they are the economic equivalent of receiving income on which the tax has been deferred.

10-10. This means that, whether an employer has made contributions on behalf of the individual, or the individual has personally made the contributions, the taxes on the amounts involved have been deferred from the year of contribution to the year of withdrawal from the plan. This period may exceed 45 years for contributions made at the beginning of an individual's working life.

### Tax Free Compounding

10-11. Also of great importance is the fact that the income earned by investments contained in these plans is not taxed until it is withdrawn. This allows earnings to accumulate at before tax rates, rather than after tax rates. Given that such plans may be in place over long periods of time, this provides for a significantly larger accumulation of assets. As illustrated in the following example, the importance of tax free accumulation should not be underestimated.

> **EXAMPLE** Mr. Kerr is a 35 year old taxpayer who pays taxes at a marginal rate of 45 percent. For the next 30 years, he has $5,000 per year of pre-tax income that he wishes to put aside for his anticipated retirement at age 65.
>
> **ANALYSIS** If Mr. Kerr contributes this amount to an RRSP, it can be deducted and no taxes will be paid on the $5,000 per year of pre-tax income. If this $5,000 per year is invested in an RRSP at a 10 percent per annum rate of return, it will accumulate to $822,470 at the end of 30 years. If the full amount is withdrawn when he reaches age 65, and he is still paying taxes at a marginal rate of 45 percent, he will be left with after tax funds of $452,359.
>
> If Mr. Kerr had not invested in an RRSP, taxes at 45 percent would have been paid on the $5,000, leaving only $2,750 per year to invest. Further, if he invests these funds at 10 percent outside of an RRSP, his after tax return will only be 5.5 percent [(10%)(1-.45)]. At this after tax rate, the investment of $2,750 per year for 30 years would result in an accumulation of only $199,198 by the time Mr. Kerr is 65 years old, less than half of the after tax accumulation resulting from using the RRSP approach.

10-12. In effect, the deferral of taxes on the deductible contributions, as well as the deferral of tax on the income from fund investments, has allowed for a larger amount of resources being available for retirement. As this fairly realistic example illustrates, the amounts involved can be very substantial.

### Early Contributions

10-13. The availability of tax free compounding in an RRSP makes it advantageous to contribute as early as possible. RRSP contributions for 2019 can be made as early as January 1, 2019, or as late as 60 days after the end of 2019. It can be demonstrated that, over a contribution period of 35 years, making contributions at the earliest date as opposed to the latest date can result in a 10 percent increase in the balance in the plan.

### Advantages At Retirement

10-14. The use of these tax deferred retirement savings plans may have additional advantages. If either federal or provincial tax rates have been lowered, the effective tax rate at the time of withdrawal may be lower than the rate when the contributions are made. Note, however, the opposite effect may arise if federal or provincial rates are increased.

10-15. In addition, for some individuals, retirement may result in a sufficient reduction in income that they find themselves in a lower tax bracket. Someone who spends their working life subject to a 50 percent tax rate could find that, subsequent to retirement, they are subject to taxes at 25 percent. As this lower rate would apply to amounts withdrawn from a retirement

savings plan, the deferral of taxation on contributions and investment earnings will result in an absolute reduction in taxes paid (tax avoidance).

10-16. Even if the individual is not paying taxes at a lower rate after retirement, there are additional advantages associated with the funds taken out of these plans. The first $2,000 of eligible pension income entitles the recipient to a credit against federal Tax Payable each year equal to 15 percent of amounts received. This is worth $300 at the federal level alone, and can be increased to $600 per couple through the pension income splitting provisions. (See Chapter 9.)

## Defined Benefit Vs. Money Purchase Plans

10-17. A major problem in the design of Canada's retirement savings system is the fact that, unlike RRSPs, DPSPs, and RRIFs, RPPs may be designed to provide a specified benefit after retirement. Such plans are normally referred to as defined benefit plans, while other types of RPPs are referred to as money purchase (a.k.a., defined contribution) plans. A basic understanding of the difference between these two types of plans is essential to the comprehension of the material in this Chapter. In view of this, the following brief descriptions are provided:

> **Defined Benefit Plans** In defined benefit plans, the plan sponsor undertakes to provide a specified benefit, usually expressed as a percentage of earnings, for each year of qualifying service. For example, such a plan might require an employer to provide a retirement benefit equal to 2 percent of an employee's average lifetime earnings for each year of service. Thus, if an employee worked for 20 years and earned an average salary of $50,000 per year, the retirement benefit would be $20,000 per year [(2%)(20)($50,000)].
>
> In promising this benefit, the employer has effectively agreed to make whatever amount of contributions is required to provide these benefits. The required amount of contributions will vary depending on a number of factors, the most important of which is earnings on fund assets. Employee turnover and employee life expectancy at retirement are also influential. In this type of plan, the employer is assuming all of the risk and uncertainty associated with these factors.
>
> **Money Purchase Plans** (a.k.a. Defined Contribution Plans) These plans are distinguished by the fact that the employer agrees to make specified contributions for each plan participant. A typical plan might find an employer agreeing to contribute 3 percent of each employee's annual wages to a fund that would be established to provide retirement benefits. The employer would have no obligations beyond making the specified contributions and the employee would have no guarantee as to the amount of the retirement benefit that is to be received.
>
> The actual benefit that will be received will be based on the amounts contributed and the rates of return earned on the investment of these contributions. In money purchase plans, it is the employee who is assuming the risk and uncertainty associated with investment of the contributed funds.

10-18. Before leaving these descriptions we would note that, while the term is not usually applied to them, RRSPs, DPSPs, and RRIFs are essentially money purchase plans. That is, the benefits to be received from such plans are based on the amounts transferred into the plan and the earnings resulting from the investment of these amounts. Such plans do not guarantee that the individual will receive a specified benefit after retirement. Currently, the only widely used retirement savings arrangement that uses the defined benefit approach is the employer sponsored RPP. However, RPPs can take either form and, for some time now, employers have been moving away from assuming the risks associated with defined benefit plans.

10-19. It is perhaps because of this trend that the government introduced Pooled Registered Pension Plans (PRPPs). These plans allow employers with a small number of employees to provide a defined contribution plan (a.k.a. money purchase plan) on a pooled basis with other employers. More recently they have introduced Target Benefit Plans for some employers. Both of these types of plans will be given some attention later in this Chapter.

# Registered Retirement Savings Plans (RRSPs)

## Basic Operations

### Establishment

10-20. The general rules for Registered Retirement Savings Plans (RRSPs) are contained in ITA 146. Under these rules, an RRSP is a trust with the individual as the beneficiary and a financial institution acting as the administrator. Financial institutions offering such plans include Canadian chartered banks, Canadian mutual funds, Canadian trust companies, Canadian credit unions, Canadian brokerage firms, and Canadian insurance companies.

10-21. Registration of the plan results in the investor being able to deduct a limited amount of contributions to the plan for income tax purposes. Further, the individual is not subject to tax on the income earned by the assets in the plan until it is withdrawn.

### Withdrawals

10-22. Amounts that an individual withdraws from an RRSP must be included in income unless received under the Home Buyers' Plan or the Lifelong Learning Plan (these programs are discussed in Paragraphs 10-103 and 10-114, respectively). Depending on the amount withdrawn, the trustee will be required to withhold a percentage of the amount withdrawn as a partial payment towards the tax that will be assessed on the withdrawal.

10-23. Withdrawals are treated as an ordinary income inclusion under ITA 56(1)(h), even if they were earned as dividends or capital gains within the plan. This latter point is important in that dividends and capital gains are normally taxed at more favourable rates than other types of income. This favourable treatment is lost when the amounts are earned inside an RRSP.

### Investment Options For An RRSP

10-24. There are two basic types of RRSPs. Managed RRSPs are managed by the financial institution that holds the fund assets. The self-administered (a.k.a. self-directed) RRSP is managed by the taxpayer. For individuals who prefer to make their own investment decisions with respect to the fund assets, the self-administered type of plan is the obvious choice.

10-25. An additional advantage of the self-administered type of plan is that the taxpayer can transfer securities that he already owns into the plan. However, with the availability of discount brokers charging minimal commissions, the importance of this advantage for many taxpayers has declined over time. As an RRSP is a separate taxable entity, such transfers are dispositions and any gains arising on the transfer will be subject to tax. Note, however, that ITA 40(2)(g)(iv) prevents the recognition of losses on such transfers.

> **EXAMPLE** An individual transfers securities to his RRSP. The shares of Company A have an adjusted cost base of $5,000 and a fair market value of $7,000. The shares of Company B have an adjusted cost base of $5,000 and a fair market value of $4,000.
>
> **ANALYSIS** While the individual would have to record a capital gain on the Company A shares of $2,000, the $1,000 loss on the shares of Company B cannot be deducted. Given this, if the taxpayer wishes to have Company B in his RRSP, it would be preferable to sell his holding and, at a later point in time, purchase the shares within the RRSP. Care should be taken to avoid the superficial loss rules (see Chapter 8).

10-26. If the taxpayer's preference is to have a financial institution manage the plan, he will be confronted with a wide variety of choices. Managed funds include those that invest entirely in equity securities, funds that hold only long-term bonds, funds with mixed portfolios, and funds that specialize in one type of asset such as mortgages.

10-27. Choosing between the alternatives involves an assessment of many factors, including the investment goals of the taxpayer, and the fees charged by the various plans. With hundreds of choices available, the decision can be a very difficult one. However, considering the amount of financial resources that may eventually be invested in RRSP assets, it is not a decision that should be made without a thorough investigation of the alternatives.

10-28. Since an individual can own any number of separate RRSPs, it is possible to have both a self-administered and a managed plan. Further diversification could be achieved by having two or more types of managed plans. However, the extra effort and costs required to keep track of the multiple plans should be considered.

10-29. The *Act* is flexible with respect to the types of investments that can be included in either a self-administered or a managed RRSP. ITR Part XLIX provides a detailed listing of the specific investment categories and includes publicly traded shares, mutual fund units, bonds, mortgages, warrants, and rights. The only significant restrictions relate to investments in the shares of private companies that are under the influence of the taxpayer, and direct investments in real estate. There is no limit on foreign content (e.g., shares of U.S. public companies). For a more complete discussion of qualified investments, see IT Folio S3-F10-C1, *Qualified Investments - RRSPs, RESPs, RRIFs, RDSPs, and TFSAs*.

10-30. While it is not likely that this is a common problem, there are rules applicable to holdings of publicly traded securities where the RRSP registrant holds more than a 10 percent interest (number of shares or fair market value). These holdings are referred to as "prohibited investments" and, significant penalties apply if they are contained in either an RRSP, a RRIF or a TFSA. These investments are discussed in detail in IT Folio S3-F10-C2, *Prohibited Investments - RRSPs, RRIFs, and TFSAs*.

10-31. It is interesting to note that an RRSP can provide a mortgage on Canadian real property to the registrant of the plan, provided that the mortgage is insured under the National Housing Act, or by some other company providing mortgage insurance. The extra costs associated with this insurance have served to limit the use of this option.

### The Capital Gains And Dividend Problems

10-32. As you are aware, when capital gains or eligible dividends are received directly by an individual, they are taxed at very favourable rates. We will not consider non-eligible dividends here as, in many circumstances, the shares of private companies cannot be held in RRSPs. As we noted in Chapter 7, an individual subject to Ontario's maximum rate of 53.5 percent, would be taxed on capital gains at 26.8 percent and eligible dividends at 39.3 percent.

10-33. In contrast, when these types of income are earned inside an RRSP, they will be taxed as ordinary income when the amounts are distributed to the registrant. In effect, for an Ontario resident in the maximum tax bracket, any capital gains or eligible dividends earned inside an RRSP will be taxed at 53.5 percent.

10-34. At first glance, this appears to be a very undesirable consequence of investing in an RRSP. However, this is mitigated by the fact that, for an individual with a specified amount of before tax funds to invest, a larger amount of funds can be invested since RRSP contributions are deductible.

**EXAMPLE** An individual has $10,000 in pre-tax income that he does not require for his current needs. His marginal tax rate is 52 percent on ordinary income and 37 percent on eligible dividends. He is considering investing in the shares of a Canadian public company in three alternative ways:

- Investing the full $10,000 through an RRSP. Note that he can invest the full amount because the contribution is deductible.
- Investing the after tax amount of $4,800 [($10,000)(1 - .52)] through a TFSA.
- Investing the after tax amount of $4,800 directly, i.e., without using either type of plan, through a trading account.

Assume that over the following 2 years the shares of the Canadian public company will increase in value by 50 percent. No dividends will be paid by the company during this period.

At the end of the 2 year period, all available funds, including maximum withdrawals from the RRSP and the TFSA, will be used to acquire a residence.

**ANALYSIS** The result for the three alternatives are as follows:

**RRSP Result**

| | |
|---|---|
| Deductible Contribution | $10,000 |
| Increase In Value [(50%)($10,000)] | 5,000 |
| Available Withdrawal | $15,000 |
| Tax On Withdrawal [(52%)($15,000)] | ( 7,800) |
| After Tax Funds Available | $ 7,200 |

**TFSA Result**

| | |
|---|---|
| Initial Investment [($10,000)(1 - .52)] | $4,800 |
| Increase In Value [(50%)($4,800)] | 2,400 |
| Available Withdrawal | $7,200 |
| Tax On Withdrawal | Nil |
| After Tax Funds Available | $7,200 |

**Direct Investment Result**

| | |
|---|---|
| Initial Investment [($10,000)(1 - .52)] | $4,800 |
| Increase In Value [(50%)($4,800)] | 2,400 |
| Available Funds | $7,200 |
| Tax On Capital Gain [(1/2)(52%)($2,400)] | ( 624) |
| After Tax Funds Available | $6,576 |

10-35. This simple example indicates that the benefits of being able to deduct contributions to an RRSP can more than offset the unfavourable tax treatment that is given to capital gains that are withdrawn from such plans. Using the RRSP results in an additional $624 ($7,200 - $6,576) in funds being available.

10-36. Note also that the deductibility of RRSP contributions and the resulting ability to invest a larger amount of funds offsets the fact that no taxes are assessed on the TFSA investment. Both the RRSP and the TFSA result in the individual having $7,200 in funds to use in acquiring a new residence.

## Exercise Ten - 1

**Subject:** Comparison Of Dividends Earned In RRSP, TFSA And Directly

Brian Forthright has $20,000 in pre tax income that he does not need currently. He is trying to decide whether it would be better to contribute the $20,000 to his RRSP and deduct the full amount, or invest the after tax amount of these funds either in a TFSA or outside either plan. He will invest the available funds in preferred shares that pay an annual eligible dividend of 5 percent. At the end of 5 years, he will use all of the available funds for an extended vacation.

Brian's combined marginal tax rate on ordinary income is 40 percent and his combined tax rate on eligible dividends is 22 percent. Ignoring the effect of any reinvestment of the dividend income, determine which of the three alternatives will provide more funds for Brian's trip.

**SOLUTION available in print and online Study Guide.**

**Figure 10 - 2**
**RRSP Deduction Limit Formula - ITA 146(1)**

"RRSP deduction limit" of a taxpayer for a taxation year means the amount determined by the formula

**A + B + R – C**, where

**A** is the taxpayer's ***unused RRSP deduction room*** at the end of the preceding taxation year,

**B** is the amount, if any, by which

(a) the lesser of the ***RRSP dollar limit*** for the year and 18% of the taxpayer's ***earned income*** for the preceding taxation year,

exceeds the total of all amounts each of which is

(b) the taxpayer's ***pension adjustment*** for the preceding taxation year in respect of an employer, or

(c) a ***prescribed amount*** in respect of the taxpayer for the year,

**C** is the taxpayer's net ***past service pension adjustment*** for the year, and

**R** is the taxpayer's total ***pension adjustment reversal*** for the year.

**Example of relevant years** Contributions made during the first 60 days of 2020 and undeducted contributions made in years prior to 2019 can be deducted against the RRSP Deduction Limit for 2019. Adding to the confusion is the fact that the RRSP Deduction Limit for 2019 is based on Earned Income for the previous year (2018), as well as a Pension Adjustment that is calculated using 2018 figures.

### *Non-Deductible Financing Costs*

10-37. As a final point, it is important to note that interest paid on funds borrowed to finance RRSP contributions is not deductible. This suggests that it may not be desirable for an individual to borrow in order to make RRSP contributions. A complete analysis of this issue requires an estimate of how long the loan will be outstanding and a comparison of the individual's borrowing rate with his expected return on funds invested in the plan.

## RRSP Deduction Limit

### *The Basic Formula*

10-38. At the heart of this retirement savings system is the RRSP Deduction Limit. It is this amount that determines the maximum contribution to an RRSP that can be deducted in a year. While this amount is sometimes referred to as the contribution limit, this is not an accurate description. The definition of RRSP Deduction Limit is found in ITA 146(1) and is reproduced in Figure 10-2. There are several technical terms included in this definition and they are highlighted in Figure 10-2 with bold, italic type. Explanations for each term will be provided in the material which follows.

10-39. The RRSP Deduction Limit is neither a limit on contributions that can be made during the current year, nor a requirement that the contributions deducted in the current year be made in that year. A limited amount of non-deductible contributions can be made that are in excess of the RRSP Deduction Limit. Further, contributions made in earlier years that were not deducted in those years, or contributions made in the first 60 days of the following year, can be deducted under the RRSP Deduction Limit for the current year.

10-40. The reason for using an Earned Income figure from a previous year is to allow an individual to determine his maximum contribution for the current year during the early part of

that year. If the limit had been based on the current year's Earned Income, an individual would have to make contributions during the year based only on an estimate of his Earned Income, a situation that would often result in contributions that are over or under the limit.

10-41. To assist taxpayers in dealing with this deduction limit calculation, the CRA issues an RRSP Deduction Limit Statement to individuals who have filed income tax returns. It is included with the Notice of Assessment and, assuming the return is filed on time, calculates the individual's maximum RRSP deduction for the year after the assessed year. The RRSP Statement is also available online through the CRA's My Account portal.

> **EXAMPLE** The RRSP Statement for the 2019 return will normally be available online or through the mail during April or May, 2019. This Statement indicates the maximum RRSP deduction for 2019. Note that this maximum deduction can be made using contributions made prior to 2019 or in the first 60 days of 2020. There is no requirement that the deduction for 2019 be based on contributions made during 2019.

### Unused RRSP Deduction Room

10-42. As it is used in the Figure 10-2 formula, a taxpayer's Unused RRSP Deduction Room at the end of the preceding year is simply the cumulative total of all of the amounts determined under the formula for years prior to the current year, less any amounts that have been deducted in those years.

10-43. This approach provides for a carry forward of deduction room that is not time limited. As a result, a taxpayer who lacks the funds to make a deductible contribution in a particular year does not lose the deduction room applicable to that year. The deduction room is carried forward and provides the basis for a deductible contribution in any future year.

### RRSP Dollar Limit

10-44. The RRSP Dollar Limit is defined in terms of the Money Purchase Limit that is specified in quantitative terms in ITA 147.1(1). The Money Purchase Limit is the annual ceiling applicable to contributions made to RPPs. Because of the one year lag in the data used for the RRSP Deduction Limit, the RRSP Dollar Limit is generally defined as the Money Purchase Limit for the preceding year.

10-45. Money Purchase Limits and the RRSP Dollar Limits for years 2016 through 2020 are as follows:

| Year | Money Purchase Limit | RRSP Dollar Limit |
|---|---:|---:|
| 2016 | 26,010 | 25,370 |
| 2017 | 26,230 | 26,010 |
| 2018 | 26,500 | 26,230 |
| **2019** | **27,230** | **26,500** |
| 2020 | Indexed | 27,230 |

### Earned Income

10-46. Earned Income for RRSP purposes is defined in ITA 146(1). Note that Earned Income for child care expense purposes (see Chapter 9) is different than Earned Income for RRSP purposes. The basic idea underlying this definition of Earned Income for RRSP purposes is that the income to be included in this designation is earned by the individual, rather than received as the result of owning property. This means that interest, dividends, and capital gains are excluded from the definition.

10-47. Surprisingly, however, net rental income is included, despite the fact that, for individuals, rental income is usually a form of property income. Another unusual feature of the definition is that it does not include either net or gross employment income in unaltered form. Rather, the net employment income component of Earned Income is a hybrid concept that excludes RPP contributions and is not used anywhere else in the determination of Net Income For Tax Purposes. Note that the deductible portion of CPP contributions payable because of

self employed income are deducted under subdivision e [ITA 60(e)]. Since this means that they do not affect the calculation of net business income, they do not affect the calculation of earned income for RRSP purposes.

10-48. As found in ITA 146(1), the basic components of Earned Income are as follows:

**Additions**

- Net employment income, computed without the deduction for RPP contributions
- Income from carrying on a business
- Net rental income from real property
- Income earned as an active partner
- Royalties, provided the recipient is the author, composer, or inventor of the work
- Taxable support payments received by a spouse.
- Research grants, net of certain related expenses
- Canada and Quebec Pension Plan disability benefits received
- Supplementary unemployment benefit plan payments (This does not include the regular Employment Insurance benefit payments)

**Deductions**

- Deductible support payments (This does not include non-deductible child support payments)
- Losses from carrying on a business
- Losses allocated to an active partner
- Losses from the rental of real property

## Exercise Ten - 2

**Subject:** Earned Income

Mr. Jarwhol Nacari has net employment income of $56,000 (he is not a member of an RPP), interest income of $22,000, net rental income of $2,500, and receives taxable support payments from his former spouse of $12,000 during the current year. What is Mr. Nacari's Earned Income for RRSP purposes for the current year?

## Exercise Ten - 3

**Subject:** Earned Income

Ms. Shelly Devine has net employment income of $82,000 (after the deduction of $3,000 in RPP contributions), a business loss of $12,500, taxable dividends of $4,200, and pays deductible support to her former spouse of $18,000 during the current year. What is Ms. Devine's Earned Income for RRSP purposes for the current year?

**SOLUTIONS available in print and online Study Guide.**

## *Pension Adjustments (PAs) - Overview*

10-49. If an individual participates in an RPP or a DPSP, his RRSP Deduction Limit must be reduced to reflect retirement savings that are taking place in these plans. If this did not happen, individuals belonging to RPPs and DPSPs could have access to larger amounts of tax deferred retirement savings than would be the case for other individuals.

10-50. Pension Adjustments (PAs) are designed to reflect the benefits earned by an individual through defined benefit RPPs or contributions made to money purchase RPPs and DPSPs by an individual or his employer during a particular year. As RPPs and DPSPs are always sponsored by an employer, the CRA requires the employer to calculate an annual PA for each

employee who is a member of that employer's RPP or DPSP. This amount is reported on the employee's T4.

10-51. Employers do not issue T4s until January or February of the year following the calendar year in which contributions are made or benefits granted. Because of this, the PA that is deducted in the calculation of the taxpayer's RRSP Deduction Limit for the current year, is based on the employer's contributions or benefits granted during the preceding year. More specifically, the 2019 RRSP Deduction Limit is reduced by PAs calculated with reference to 2018 RPP benefits earned and RPP and DPSP contributions made. These PAs are reported to the CRA and the taxpayer in the 2018 T4s that are issued in January or February of 2019. These PAs are also incorporated into the 2019 RRSP Deduction Limit Statement that the CRA issues for the 2019 taxation year.

## Exercise Ten - 4

**Subject:** Retirement Savings

How does the Canadian retirement savings system prevent individuals who are a member of their employer's RPP or DPSP from being treated more favourably than individuals who can only use an RRSP for retirement savings?

**SOLUTION available in print and online Study Guide.**

### *Pension Adjustments - Money Purchase RPPs And DPSPs*

10-52. The calculation of PAs for money purchase plans is relatively straightforward. As RRSPs operate in the same general format as money purchase plans (i.e., they do not promise a specific benefit), contributions to money purchase plans are directly comparable, on a dollar for dollar basis, with contributions to an RRSP.

10-53. As a consequence, the PA for a money purchase RPP is simply the sum of all employee and employer contributions for the year. Following the same reasoning, an employee's PA for a DPSP is simply the employer's contributions for the year that are allocated to the individual (employees cannot contribute to a DPSP). Since the PA that is deducted already includes the employee's contributions to the RPP, the net employment figure used to calculate earned income must add back RPP contributions so they are not deducted twice. A simple example will illustrate these calculations:

**EXAMPLE** Ms. Jones' employer sponsors a money purchase RPP and a DPSP. Ms. Jones is a member of both. During 2018, she has net employment income of $68,000 after the deduction of her $2,000 contribution to the RPP. This results in Earned Income of $70,000 ($68,000 + $2,000). Her employer contributes $2,000 to the RPP and $1,500 to the DPSP on her behalf. She has no Unused RRSP Deduction Room at the end of 2018.

**ANALYSIS** Ms. Jones' 2018 PA is $5,500 ($2,000 + $2,000 + $1,500), an amount that will be reported on the 2018 T4 that she will receive in early 2019. After filing her 2018 tax return, Ms. Jones will have access to her RRSP Deduction Limit Statement for 2019 from the CRA that will calculate her 2019 maximum RRSP contribution.

As she has no Unused RRSP Deduction Room at the end of 2018, her RRSP Deduction Limit will be calculated by taking the lesser of the $26,500 RRSP Dollar Limit for 2019 and $12,600, 18 percent of Ms. Jones' 2018 Earned Income of $70,000. The 2018 PA of $5,500 will be subtracted from the lesser figure of $12,600, to arrive at her maximum deductible RRSP contribution for 2019 of $7,100.

### Pension Adjustments - Defined Benefit RPPs

10-54. As defined benefit plans guarantee the benefit to be provided, rather than specify the amount of contributions required, contributions made to these plans cannot be compared directly to contributions made to RRSPs, DPSPs, or money purchase RPPs. However, if retirement savings limits are to be applied equitably to all individuals, without regard to the type of arrangements available to them, it is necessary to find a basis for equating the benefits earned under these plans with the contributions made to the other types of plans.

10-55. It is unfortunate that there is no simple way to convert a benefit earned into an equivalent amount of contributions. While there are a number of problems in dealing with this conversion, the most significant is the age of the employee. Because of the difference in years during which earnings will accumulate, it costs an employer much less in terms of current contributions to provide a $1 per year retirement benefit to an employee who is 25 years old and 40 years away from receiving that benefit, than it does to provide the same retirement benefit to an employee who is 60 years old and only 5 years away from receiving the benefit.

10-56. To have a completely equitable system for dealing with this problem, different values would have to be assigned to benefits that are earned by employees of different ages. Benefits earned by older employees would have to be assigned a higher value than those earned by younger employees. Unfortunately, it appears that the government believes that the benefits of such an equitable system do not warrant the costs of associating different levels of benefits with individuals of differing ages.

10-57. Rather than a system that takes into account the different ages of participants in defined benefit RPPs, the current solution is to equate $1 of benefits earned with $9 of contributions. If, during the current year, an individual earns $1 of future benefits under the provisions of a defined benefit RPP, in the calculation of his PA for the year, this will be viewed as the equivalent of $9 in contributions to a money purchase RPP or DPSP. Unlike the case of money purchase plans, the amounts contributed to the plan by the employer and employee during the year do not affect the PA.

10-58. The use of the multiple 9 is an arbitrary solution that fails to give any consideration to the age of the employee (there is an unconfirmed rumour that this number was selected because it was the shoe size of the Minister of Finance at the time the legislation was passed). It is systematically unfair to younger individuals as it overstates the cost of providing their pension benefits, thereby generating an excessive PA which, in turn, creates a corresponding reduction in their ability to contribute to their RRSP.

> **EXAMPLE** Bryan is 25 years of age. In 2019, he earns a pension benefit in his employer's defined benefit RPP of $1,000 to be received beginning in 2059 when Bryan reaches 65 years of age. His PA for 2019 is $9,000 which decreases his RRSP deduction room by $9,000.
>
> **ANALYSIS** In return for a $1,000 per year pension after 40 years, Bryan has lost $9,000 in RRSP contribution room. Assuming that he would have used this room to make a $9,000 contribution in 2019, this contribution would have accumulated, assuming a 10 percent rate of return, to $407,331 in 2059. This balance would clearly produce an income stream well in excess of the pension benefit of $1,000 per year. Even if the $407,331 was invested at an extreme low rate of 1 percent, it would still produce income of $4,073 per year, more than 4 times the income provided by the RPP.
>
> While this comparison is not a complete analysis of the situation (it does not consider the costs of the two alternatives), it does illustrate the fact that, when a pension benefit given to a young individual is multiplied by 9, there is a very high cost in terms of lost RRSP contribution room.

10-59. While it was probably essential to the implementation of this system that some type of averaging process be used, it is unfortunate that the selected alternative has such a systematic bias against younger individuals. It is unlikely that the government could have arrived at

any administratively convenient solution that would not appear inequitable to some individuals. However, it would have been more equitable to have used some type of age dependent sliding scale, as opposed to the inflexible application of the factor of 9.

## Exercise Ten - 5

**Subject:** Pension Adjustments

Mr. Arnett's employer sponsors both a money purchase RPP and a DPSP. During the current year, his employer contributes $2,300 to the RPP and $1,800 to the DPSP on behalf of Mr. Arnett. Mr. Arnett contributes $2,300 to the RPP. Calculate the amount of the Pension Adjustment that will be included on Mr. Arnett's T4 for the current year.

**SOLUTION available in print and online Study Guide.**

### *Prescribed Amount - ITA 146(1)*

10-60. The Prescribed Amount (see Figure 10-2) is a deduction that may arise as the result of an individual transferring accumulated benefits from one RPP to a different RPP. We will not give any attention to the calculation of this amount in this text.

### *Past Service Pension Adjustments (PSPAs)*

10-61. Past Service Pension Adjustments (PSPAs) are designed to deal with benefits under defined benefit RPPs related to credit for past service. They are far less common than PAs. Some of the events giving rise to PSPAs are as follows:

- A new RPP is implemented by an employer and benefits are extended retroactively for years of service prior to the plan initiation.
- The benefit formula is changed, increasing the percentage that is applied to pensionable earnings to determine benefits earned. Again, a PSPA is created only if the increased benefits are extended retroactively to years of service prior to the plan amendment.
- An individual, either voluntarily or because of terms contained in the plan, works for a number of years without being a member of the plan. On joining the plan, the employee is credited for years of service prior to entry into the plan.

10-62. If an individual were to receive such past service benefits without experiencing any reduction in his RRSP Deduction Limit, he would have effectively beaten the system. That is, he would be receiving additional pension benefits over and above the limits that are normally applicable to individual taxpayers. The role of PSPAs is to prevent this from happening.

10-63. PSPAs are calculated on the basis of all of the PAs that would have applied in the years prior to the year of change if the plan or improvement had been in effect, or if the individual had been a member in those years. From these "as if" PAs, the actual PAs reported would be deducted. The resulting difference is then reported as a PSPA for the current year.

10-64. As with PAs, the employer is responsible for calculating and reporting PSPAs, normally within 60 days of the past service event. The amount is reported on a PSPA information form (not on a T4) that is sent to both the employee and the CRA. Since the current year's PA will reflect the new benefits, only years prior to the year of change are used to calculate the PSPA. As a result, unlike the one year lag in deducting PAs, PSPAs are deducted from the RRSP deduction room formula in the year in which they occur.

10-65. The following simplified example illustrates very basic PSPA calculations:

**EXAMPLE** Wally Oats has been a member of his employer's defined benefit RPP since 2013. Until 2019, the benefit formula provided a retirement benefit equal to 1.5 percent of pensionable earnings for each year of service. During 2019, the benefit

formula was increased to 1.75 percent of pensionable earnings for each year of service, a change that is to be applied to all prior years of service. Mr. Oats has had $48,000 in pensionable earnings in each prior year.

**ANALYSIS** The calculation of the PSPA for 2019 would be based on the six years of service prior to the current year (2013 to 2018) as follows:

| | |
|---|---|
| New Formula PAs [(1.75%)($48,000)(9)(6 Years)] | $45,360 |
| Previously Reported PAs [(1.50%)($48,000)(9)(6 Years)] | ( 38,880) |
| 2019 PSPA | $ 6,480 |

10-66. Note that PSPAs only occur in the context of defined benefit plans. If additional contributions for past service are made to a money purchase plan, these amounts will be included in the regular Pension Adjustment for the year in which the contributions are made. This eliminates the need for any sort of catch up adjustment.

## Pension Adjustment Reversals (PARs)

10-67. A vested pension benefit is one in which the employee has an irrevocable property right. That is, he is entitled to receive the value of the benefit, without regard to whether he remains an employee of the employer providing the benefit.

10-68. In order to give their employees an incentive to remain with them, many employers grant pension benefits that do not become vested unless the employee remains for a specified period of time. A common arrangement would be for an employer to grant benefits that do not vest until the employee has completed 5 years of service. If an employee leaves before the end of this 5 year period, he loses the benefits that he has earned to that point in time.

10-69. This creates a problem in that employers are required to report PAs for all benefits or contributions earned by an employee during the year, regardless of when the pension benefits become vested. This means that an employer may report PAs for benefits that will not, in fact, be received by the employee. This, in turn, means that the RRSP deduction room that was eliminated by these PAs would also be lost.

10-70. To deal with this problem, Pension Adjustment Reversals (PARs) were added to the pension legislation. Note that this is only an issue with the employer's share of contributions made or benefits earned. Provincial legislation requires that employees have a vested right to all of their own contributions.

10-71. A PAR is calculated by the employer whenever an employee terminates membership in an RPP or DPSP and receives less from the plan than the total of the PAs and PSPAs reported for the employee. The PAR is reported to the CRA and to the employee, and will be added to the individual's RRSP deduction room in the year of termination. The following simple example illustrates the use of a PAR:

**EXAMPLE** Stan Kapitany is a member of an RPP in which benefits are not vested until the fourth year of service. He leaves after 3 years when he is offered an opportunity to develop high performance race cars. His employer was required to report PAs for the first 3 years of his employment and this, in turn, reduced Mr. Kapitany's ability to make deductible contributions to an RRSP.

**ANALYSIS** Since he ceases to work for his employer prior to the benefits becoming vested, the benefits for which PAs were previously reported will not be transferred to him. This means that there will be no retirement benefits corresponding to the previously reported PAs and, as a consequence, Mr. Kapitany has lost a portion of his entitlement to tax deferred retirement savings. This problem is solved with the addition of a PAR to Mr. Kapitany's RRSP deduction room.

**We suggest you work Self Study Problem Ten-1 at this point.**

## Examples Of RRSP Deduction Calculations

10-72. The following three examples illustrate the calculation of the RRSP Deduction Limit, Unused RRSP Deduction Room, and the carry forward of undeducted RRSP contributions.

**Example A**

Miss Brown has 2018 net employment income of $30,000, 2018 net rental income of $10,000, and 2018 interest income of $5,000. She is not a member of an RPP or a DPSP. She contributes $5,000 to her RRSP in October, 2019 and $800 in January, 2020. At the end of 2018, her Unused RRSP Deduction Room was nil and she had undeducted contributions of $1,000 in her RRSP account.

| | |
|---|---|
| Unused Deduction Room Carried Forward From 2018 | Nil |
| Lesser Of: | |
| • 2019 RRSP Dollar Limit = $26,500 | |
| • 18% Of 2018 Earned Income Of $40,000 = $7,200 | $7,200 |
| 2019 RRSP Deduction Limit | $7,200 |
| RRSP Deduction ($5,000 + $800 + $1,000) | ( 6,800) |
| Unused Deduction Room - End Of 2019 | $ 400 |

The interest income is not included in Earned Income as defined in ITA 146(1).

**Example B**

After deducting an RPP contribution of $2,000, Mrs. Blue has 2018 net employment income of $34,000. Her employer reports a PA of $4,500 on her 2018 T4. Her 2019 RRSP contributions total $5,000 and she deducts $3,200 in her 2019 tax return. At the end of 2018, her Unused RRSP Deduction Room was $2,500 and there were no undeducted contributions in her RRSP account.

| | |
|---|---|
| Unused Deduction Room Carried Forward From 2018 | $2,500 |
| Lesser Of: | |
| • 2019 RRSP Dollar Limit = $26,500 | |
| • 18% Of 2018 Earned Income Of $36,000 = $6,480 | 6,480 |
| Less 2018 PA | ( 4,500) |
| 2019 RRSP Deduction Limit | $4,480 |
| RRSP Deduction ($5,000 Contributed) | ( 3,200) |
| Unused Deduction Room - End Of 2019 | $1,280 |

Mrs. Blue has 2018 Earned Income of $36,000 (net employment income of $34,000, plus her $2,000 RPP contribution that was deducted). She has an undeducted RRSP contribution of $1,800 ($5,000 - $3,200). She can deduct $1,280 in any subsequent year, but needs $520 of additional RRSP deduction room to deduct the remainder.

**Example C**

Mr. Green receives taxable 2018 spousal support of $150,000 and has no other source of income during 2018. He is not a member of an RPP or DPSP. In January, 2020, he contributes $11,500 to his RRSP. This full amount is deducted in his 2019 tax return. His Unused RRSP Deduction Room carried forward from 2018 was $1,200 and there were no undeducted contributions in his RRSP account.

| | |
|---|---|
| Unused Deduction Room Carried Forward From 2018 | $ 1,200 |
| Lesser Of: | |
| • 2019 RRSP Dollar Limit = $26,500 | |
| • 18% Of 2018 Earned Income Of $150,000 = $27,000 | 26,500 |
| 2019 RRSP Deduction Limit | $27,700 |
| RRSP Deduction ($11,500 Contributed) | ( 11,500) |
| Unused Deduction Room - End Of 2019 | $16,200 |

## Exercise Ten - 6

**Subject:** Unused RRSP Deduction Room

Mr. Victor Haslich has 2018 Earned Income for RRSP purposes of $38,000. He is not a member of an RPP or a DPSP. His Unused RRSP Deduction Room carried forward from 2018 was $4,800. During 2019, he contributes $6,000 to his RRSP and makes an RRSP deduction of $4,500. What is the amount of Mr. Haslich's Unused RRSP Deduction Room and undeducted RRSP contributions at the end of 2019? If instead of deducting only $4,500, Mr. Haslich wanted to deduct his maximum RRSP deduction, how much more would he have to contribute to do so?

## Exercise Ten - 7

**Subject:** Maximum RRSP Deduction

During 2018, Mr. Black has taxable capital gains of $23,650, net rental income of $6,530, pays spousal support of $18,000, and has net employment income of $75,600. Based on his RPP contributions of $2,400 and the matching contributions made by his employer, his employer reports a 2018 PA of $4,800. Mr. Black has Unused RRSP Deduction Room carried forward from 2018 of $10,750. Also at this time, his RRSP contains undeducted contributions of $6,560. During 2019, he makes contributions to his RRSP of $13,200.

Determine Mr. Black's maximum RRSP deduction for 2019. Assuming he deducts his maximum, determine the amount of any Unused RRSP Deduction Room that he will have available at the end of 2019, and indicate whether he has any undeducted contributions remaining at the end of 2019.

**SOLUTIONS available in print and online Study Guide.**

# Undeducted RRSP Contributions

## General Rules

10-73. As we have previously noted, there is no requirement that contributions made to an RRSP be deducted immediately. If an individual has available funds to invest, it may be desirable to transfer these funds into an RRSP in order to enjoy the tax deferral on investment earnings that these arrangements provide. However, in some situations, it may be desirable to defer the deduction of all or part of these contributions.

10-74. An example of this type of situation would be a taxpayer who is currently in a low tax bracket and expects to be in a higher bracket in the future. Contributions made now can be deducted in any subsequent year. There is no time limit on the deductibility of unused contributions.

## Excess RRSP Contributions

10-75. As long as an individual has a corresponding amount of available deduction room, the CRA is not concerned about undeducted contributions. However, because of the desirability of having earnings accumulate on a tax free basis inside an RRSP, it is not surprising that rules have been developed to limit the amount of contributions that are in excess of an individual's deduction room.

10-76. The basic limiting provision is found in ITA 204.1(2.1) which imposes a tax of 1 percent per month on the "cumulative excess amount in respect of registered retirement savings plans". The "cumulative excess" is defined in ITA 204.2(1.1), as undeducted contributions in excess of the sum of the RRSP Deduction Limit, plus a $2,000 cushion. This, in effect, means that the penalty applies to undeducted contributions that are more than $2,000

greater than the individual's RRSP Deduction Limit.

10-77. This $2,000 cushion provides for a margin of error when a taxpayer makes contributions early in the taxation year on the basis of estimates of the amount that will be deductible. Note, however, the $2,000 cushion is only available to individuals who are 18 years of age or older throughout the year. This is to prevent parents from making undeducted contributions to an RRSP in the name of their minor children.

10-78. The following simple example illustrates the application of this rule.

**EXAMPLE** At the beginning of 2018, Mr. Woods has an RRSP Deduction Limit of nil and no undeducted contributions in his plan. During 2018, his RRSP Deduction Limit increases by $9,000. On April 1, 2018, Mr. Woods makes a contribution of $10,000 to his RRSP. No RRSP deduction is taken for 2018.

During 2019, his RRSP Deduction Limit increases by $10,000. On July 1, 2019, $15,000 is contributed to the plan. No RRSP deduction is taken for 2019.

**ANALYSIS** There would be no penalty for 2018 as his $10,000 in undeducted contributions is only $1,000 more than his $9,000 unused deduction room for 2018. There would, however, be a penalty in 2019. It would be calculated as follows:

| | January To June | July To December |
|---|---|---|
| Undeducted RRSP Contributions | $10,000 | $25,000 |
| RRSP Deduction Limit ($9,000 + $10,000) | ( 19,000) | ( 19,000) |
| Cushion | ( 2,000) | ( 2,000) |
| Monthly Cumulative Excess Amount | $ Nil | $ 4,000 |
| Penalty Rate | 1% | 1% |
| Monthly Penalty | $ Nil | $ 40 |
| Number Of Months | N/A | 6 |
| Total Penalty | $ Nil | $ 240 |

## Exercise Ten - 8

**Subject:** Excess RRSP Contributions

Ms. Lucie Brownell is not a member of an RPP or a DPSP. At the beginning of 2018, Ms. Brownell has no Unused RRSP Deduction Room. During 2017 and 2018 she has Earned Income of $160,000 each year. On July 1, 2018, she makes a $27,350 RRSP contribution, but does not take any deduction for the year. In 2019, she has Earned Income of $50,000, makes a $30,000 contribution on May 1, but still does not take a deduction for the year. Determine any penalty that will be assessed to Ms. Brownell for excess contributions during either 2018 or 2019.

**SOLUTION available in print and online Study Guide.**

### *Tax Planning - Excess RRSP Contributions*

10-79. It would be very difficult to find an investment for which the elimination of tax effects would offset a non-deductible penalty of 1 percent per month (12 percent annually). Clearly, excess contributions that subject the taxpayer to this penalty should be avoided.

10-80 If excess contributions are withdrawn from the RRSP prior to the end of the year following the year in which an assessment is received for the year in which the contribution is made, an offsetting deduction is available. If, however, any excess is not withdrawn within this specified time frame, it will be included in income and taxed on withdrawal, even though it was never deducted from income.

10-81. This still leaves the question of whether it is worthwhile to make use of the $2,000 penalty free cushion. If an individual has no contribution room left in his TFSA and still has an additional $2,000 in available funds, the ability to have earnings compound on a tax free basis within the RRSP would usually make this a desirable strategy.

10-82. Alternatively, if an individual has not contributed the maximum allowable to his TFSA and only has limited funds available for investment, the TFSA would be the preferable alternative. This reflects the fact that, while both the TFSA and the non-deductible contributions to an RRSP enjoy tax-free compounding of earnings, withdrawals from a TFSA are not subject to tax. In contrast, any withdrawal from an RRSP, even amounts that have not been deducted, will be subject to tax.

**We suggest you work Self Study Problems Ten-2, 3, 4, and 5 at this point.**

## RRSP And RRIF Administration Fees

10-83. Administration fees for these plans, as well as investment counseling fees related to investments in these plans, cannot be deducted by an individual. As a consequence, such fees should be paid with funds that are in the plan. While there was some controversy associated with this issue, it has been concluded that such payments are not a withdrawal from the plan, nor do they create a taxable benefit for the taxpayer.

## RRSP Withdrawals And Voluntary Conversions

### *Lump Sum Withdrawals*

10-84. A lump sum withdrawal from an RRSP is possible at any point in time. The tax consequences of partial or complete withdrawals are very straightforward. In general, the amount withdrawn must be added to income in the year of withdrawal. Further, as a withdrawal does not result in an increase in the ability to make future contributions, such transactions result in a permanent reduction in the balances that will enjoy tax free earnings accumulation.

10-85. Even when the individual is at or approaching retirement, a lump-sum withdrawal of all funds would not usually be a reasonable alternative. This course of action could subject a large portion of the withdrawal to maximum tax rates at that time and, in the absence of other retirement income, would result in lost tax credits in subsequent years.

10-86. We would also call your attention to the fact that lump sum withdrawals are subject to withholding. The trustee of the plan is required to withhold a portion of the funds withdrawn and remit them to the government. The taxpayer will, of course, be able to use these withholdings to offset the taxes that will be assessed on the amounts withdrawn. Withholding is based on the following schedule:

| Amount | Rate |
|---|---|
| Less Than $5,001 | 10% |
| $5,001 To $15,000 | 20% |
| More Than $15,000 | 30% |

10-87. An additional point with respect to lump sum RRSP withdrawals is that such amounts are not eligible for the pension income tax credit or the pension income splitting provisions that are available to couples (see Chapter 9).

### *Conversion To Income Stream*

10-88. Besides lump sum withdrawals, the following options are available for converting an RRSP into an income stream:

**Life Annuity** Funds from within an RRSP can be used to purchase a single life annuity or, alternatively, a joint life annuity with a spouse or common-law partner. Taxation occurs only as the annuity payments are received.

Note that a life annuity can guarantee that it is paid for a minimum number of periods. For example, a life annuity with a ten year guaranteed term would make payments for a minimum of ten years, even if the annuitant died prior to the end of the period.

A possible point of confusion here is the use of the term annuitant. In most dictionaries, this term refers to someone who is actually receiving an annuity. In contrast, the *Income Tax Act* uses the term to refer to someone who is entitled to receive an annuity, even if payments under the annuity arrangement have not commenced.

**Fixed Term Annuity** In a similar fashion, a fixed term annuity can be purchased. As with the life annuity, taxation would occur as the annuity payments are received.

**March 19, 2019 Federal Budget** In order to provide greater flexibility in the use of retirement funds, the Federal Budget has proposed the introduction of two additional types of annuities. They can be described as follows:

- **Advanced Life Deferred Annuity (ALDA)** Reflecting increased life expectancies and decisions by individuals to keep working beyond conventional retirement ages, the budget proposes to allow ALDAs to be purchased with RRSP funds, as well as with funds from other registered plans such as Registered Retirement Income Funds (RRIFs). Within prescribed limits, these life annuities allow for the initial payment to be deferred until age 85.
- **Variable Payment Life Annuities** Rather than requiring a fixed payment throughout an individual's life, these life annuities allow payments to be adjusted based on such factors as the consumer price index and the investment performance of the underlying funds. This type of annuity can only be created with funds from either a Registered Pension Plan (RPP) or a Pooled Registered Pension Plan (PRPP).

The legislation for these two new types of annuities will be fairly complex and at this point in time (April, 2019) has not been released. Detailed coverage of the rules associated with these annuities is beyond the scope of this text.

**Reminder** With respect to annuities purchased with tax deferred funds, the full amount of the payments must be included in Net Income For Tax Purposes. In contrast, for annuities purchased with after-tax funds, the full amount of payments are not subject to tax as the taxpayer can deduct the capital component of the payment (see Chapter 9).

10-89. These conversions can be made at any age, and without regard to whether the taxpayer has retired. Further, there are no tax consequences resulting from the conversion. As noted, the annuity payments will be included, in full, in the taxpayer's Net Income For Tax Purposes.

10-90. Unlike lump sum withdrawals, annuity payments resulting from RRSP conversions are eligible for both the pension income tax credit and the pension income splitting provisions.

### Conversion To RRIF

10-91. A final alternative for winding up an RRSP is as follows:

**Registered Retirement Income Fund (RRIF)** The funds can be transferred on a tax free basis to one or more Registered Retirement Income Funds (RRIFs). This arrangement will be described beginning in Paragraph 10-168.

## Involuntary Termination Due To Age Limitation

### Objective

10-92. The options for termination of an RRSP that were discussed in the preceding section are available at any age and without regard to whether the individual actually retires. However, government policy in this area takes the view that the tax sheltering features of RRSPs should not continue to be available to taxpayers in periods that are substantially

beyond normal retirement age. Because of this view, RRSPs must be terminated in the year an individual turns 71.

### Post Termination

10-93. While individuals cannot have their own RRSP after reaching the age of 71, it is still possible for such individuals to make deductible RRSP contributions. If their spouse or common-law partner has not reached the age of 71, and if the individual continues to have income that qualifies as Earned Income for RRSP purposes (pension income does not), contributions can still be made to an RRSP in the name of the spouse or common-law partner.

## Spousal RRSP

### Benefits

10-94. Under ITA 146(5.1), a taxpayer can deduct payments that are made to a plan that is registered in the name of a spouse or common-law partner. Any RRSP that is registered with the taxpayer's spouse or common-law partner as the registrant, and to which the taxpayer has made a contribution, is considered to be a spousal RRSP. This means that, if an individual makes any contribution to his spouse or common-law partner's existing RRSP, that plan becomes a spousal RRSP, even if the great majority of the contributions were made by the individual's spouse or common-law partner. Note that this term is still the most commonly used, despite the fact that the legislation covers both spouses and common-law partners.

10-95. Unlike the pension income splitting provision which is only available to couples who have eligible pension income, a spousal RRSP is an income splitting plan that is available to all couples. In situations where one spouse or common-law partner is likely to have either no retirement income or a significantly lower amount, having the spouse or common-law partner with the higher expected retirement income make contributions to a plan in which the spouse or common-law partner is the registrant will generally result in the withdrawals from the plan being taxed at lower rates.

10-96. In addition, if one spouse or common-law partner has no other source of qualifying pension income, a spousal RRSP allows that individual to make use of the $300 [(15%)($2,000)] annual pension income credit against Tax Payable. Note, however, that in most circumstances, the provision for splitting pension income could accomplish this same goal.

10-97. When an individual makes contributions to an RRSP in the name of his spouse or common-law partner, the contributions will be deductible in the contributor's tax return. However, the contributor must have available deduction room and, as you would expect, contributions to a spousal plan erode this room in exactly the same manner as would contributions to an RRSP in the contributor's name.

10-98. We have noted previously that an individual can continue making contributions to a spousal RRSP, even if his own plan has been collapsed because he is over 71 years of age. In addition, a deceased taxpayer's representative can make contributions to a spousal RRSP for up to 60 days after the end of the year in which the taxpayer dies.

### Attribution Rules

10-99. The objective of all of the RRSP legislation is to encourage retirement savings. In the case of spousal RRSPs, the legislation also provides for an element of income splitting. However, as the federal government does not want this element of income splitting to override the basic objective of retirement savings, there is an income attribution provision that discourages the use of spousal RRSPs in a manner that, in effect, provides for an immediate transfer of income to a lower income spouse.

10-100. ITA 146(8.3) contains an income attribution provision that requires certain withdrawals from a spousal RRSP to be attributed to the spouse or common-law partner who made the contribution. Withdrawals from non-spousal RRSPs are normally taxed in the hands of the registrant. However, if a registrant makes a withdrawal from a spousal RRSP, and the

registrant's spouse or common-law partner has made a contribution to the plan, either in the current year or in the two preceding calendar years, the lesser of the withdrawal or the total of the spousal contributions in the 3 years will be attributed to the contributing spouse or common-law partner. The registrant of the plan will not be taxed on this amount.

10-101. Other considerations related to the application of this rule are as follows:

- This attribution rule applies to withdrawals up to the amount of the relevant contributions, but does not apply to withdrawals in excess of this amount.
- This attribution rule applies without regard to whether the contributing spouse or common-law partner has deducted the contributions.
- This attribution rule is applicable even when there are funds that were contributed by the registrant of the plan prior to the spouse or common-law partner making additional contributions.
- This attribution rule does not apply when the taxpayer and spouse or common-law partner are living apart due to a marital breakdown at the time of the withdrawal.
- It is the calendar year in which the spousal contributions are made that is relevant, as a February 1, 2020 contribution is counted in 2020, even if it is deducted in 2019.

10-102. When the taxpayer's spouse or common-law partner is eligible to make his or her own contributions to an RRSP, it can be useful to have these contributions made to a separate, non-spousal RRSP. If there is a need to withdraw funds, this precaution allows the withdrawal to be made from a plan that has not received spousal contributions. As a result, there would be no attribution and the withdrawal would be taxed in the hands of the individual making the withdrawal. However, if no withdrawals are anticipated in the foreseeable future, there is no tax related need to have a separate, non-spousal plan.

### Exercise Ten - 9

**Subject:** Spousal RRSP

During 2017, Mr. Garveau makes a $5,000 contribution to a new RRSP in which he is the registrant. His wife, Mrs. Charron Garveau also makes a $5,000 contribution to his RRSP in 2017. In 2018, Mrs. Garveau does not make any further contribution to her husband's RRSP. However, Mr. Garveau makes a $6,500 contribution. During 2019, Mr. Garveau withdraws $9,000 from his RRSP. How will this withdrawal be taxed?

**SOLUTION available in print and online Study Guide.**

## Home Buyers' Plan (HBP)

**BYRD/CHEN NOTE** The March 19, 2019 Federal Budget proposes two changes in the rules related to the Home Buyers' Plan. They can be described as follows:

- Proposals are made which will extend access to the Home Buyers' Plan in order to help Canadians maintain their home ownership after the breakdown of a marriage. These changes will not be implemented until 2020.
- The maximum withdrawal will be increased from the pre-Budget level of $25,000 per individual to $35,000 per individual. It is proposed that this change will apply only to withdrawals made after the budget date, March 19, 2019.

As this text largely deals with the 2019 taxation year, the first of the two changes has no relevance to this edition. The second change creates a situation where the maximum withdrawal is $25,000 for the period January 1, 2019 through March 19, 2019, then becomes $35,000 for the remainder of the year.

Given that the $25,000 maximum is applicable for part of 2019, we have not changed the text or problem material to reflect the proposed increase to $35,000.

### Qualifying HBP Withdrawals

10-103. The Home Buyers' Plan (HBP) permits a non-taxable withdrawal of "eligible amounts" from one or more of an individual's RRSPs. The current limit on non-taxable withdrawals is $25,000. In order to receive this withdrawal without tax consequences, the individual must meet several conditions:

- On January 1 of the year of withdrawal, all amounts related to previous HBP withdrawals must have been repaid.
- All amounts, up to the limit of $25,000 per individual, must have been received in a single year or by the end of January of the following year.
- The individual must have bought or built a "qualifying home" before October 1 of the year following the year of withdrawal(s). Extensions of the deadline are available where there is a written agreement to purchase a home, or payments have been made towards the construction of a home, by the October 1 deadline. A "qualifying home" is defined as a housing unit located in Canada, including a share of the capital stock of a cooperative housing corporation that provides an equity interest in the housing unit.
- Within one year of the acquisition of this "qualifying home", the taxpayer must begin, or intend to begin, using it as a principal place of residence. Note, however, there is no minimum holding period for the home, provided that at some point it becomes a principal residence.
- Neither the individual nor his spouse or common-law partner can have owned a home that he or she has occupied during the four calendar years preceding the withdrawal. However, there is an exception to this constraint for disabled individuals. More specifically, if the home purchase is being made by, or for the benefit of, an individual who qualifies for the disability tax credit (see Chapter 4), and the home is more accessible for the individual, or is better suited for the care of the individual, the HBP can be used even if the individual owned a home that was occupied during the specified four year period.
- The individual must complete Form T1036, Home Buyers' Plan Request To Withdraw Funds From An RRSP.

10-104. There is nothing in these rules to prevent withdrawals by both an individual and his or her spouse or common-law partner, provided all of the withdrawn funds are used to acquire a single property. This would allow couples to make withdrawals totaling $50,000 towards the purchase of a home.

### Restrictions On The Deduction Of New RRSP Contributions

10-105. The intent of this legislation is to allow individuals, who have not recently owned a home, to use accumulated RRSP contributions to acquire a residence. The government does not want to allow individuals to abuse the HBP by making contributions that are immediately withdrawn. To prevent this from happening, a special rule denies a tax deduction for contributions to an RRSP or a spousal RRSP that are withdrawn within 90 days under the Home Buyers' Plan.

10-106. For this purpose, contributions to an RRSP within the 90 day period will not be considered to be part of the funds withdrawn, except to the extent that the RRSP balance after the withdrawal is less than the amount of the new contributions. This means that an individual can make the maximum $25,000 withdrawal and still make deductible contributions in the preceding 90 days, provided they had at least $25,000 in the RRSP prior to making the additional contributions.

**EXAMPLE** At the beginning of 2019, Mr. Garth has an accumulated RRSP balance of $20,000. In order to make the maximum $25,000 HBP withdrawal, he makes a $5,000 contribution to the RRSP on June 1, 2019. If he then withdraws the $25,000

within 90 days of making the $5,000 contribution, the resulting nil balance will be less than the amount of the contribution and no deduction will be allowed for the $5,000 contribution. If Mr. Garth withdrew only $17,000, the resulting $8,000 balance will be greater than the $5,000 contribution and the contribution will be deductible.

10-107. As a final point you should note that this rule is applied on a plan by plan basis. If a withdrawal under the HBP serves to reduce the balance of a particular plan below the level of contributions made in the preceding 90 days, the contributions will not be deductible to the extent of this deficiency. This would be the case even if the taxpayer has balances in excess of $25,000 in other RRSPs.

### Repayment Of HBP

10-108. Eligible amounts are not taxed when they are withdrawn from the RRSP and, if there was not a requirement for these funds to be returned to the plan at some point in time, they would constitute a significant tax free leakage from the retirement savings system. As a consequence, repayment of amounts withdrawn must begin as per a specified schedule in the second calendar year following the year of withdrawal.

10-109. Any RRSP contribution made during the year, or in the first 60 days of the following year, can be designated an HBP repayment. These designated repayments are not deductible in the determination of Net Income For Tax Purposes. Repayments under the specified schedule must begin in the second year following the withdrawal.

10-110. Any amounts that are not returned to the plan as per the required schedule will be included in the taxpayer's income in the year in which they were scheduled to be repaid and deducted from the outstanding HBP balance. There is no upper limit on the amounts that can be repaid in any year subsequent to withdrawal, but repayment must be made within 16 years. This is accomplished by requiring a minimum repayment based on the following balance:

| | |
|---|---|
| Eligible Amounts Withdrawn | $xx,xxx |
| Repayments In Previous Years | ( xxx) |
| Amounts Included In Income In Previous Years | ( xxx) |
| Balance | $ x,xxx |

10-111. A fraction is then applied to this balance, beginning at 1/15 for the second year following the withdrawal. In each subsequent year, the denominator of the fraction is then reduced by one, resulting in 1/14 for the third year after withdrawal, 1/13 for the fourth year after withdrawal, and so on, until the fraction reaches 1/1 in the sixteenth year following the withdrawal. These are minimum payments and, if they are made as per this schedule, there will be a 15 year, straight line repayment of the eligible amounts.

10-112. If the payments are less than these minimum amounts, any deficiency must be included in that year's Net Income For Tax Purposes. As any income inclusions will be deducted from the balance to which the fraction is applied in the same manner as if they were repayments, this will not alter the schedule for the remaining payments.

10-113. However, if payments are accelerated in any year, the schedule is changed. While the multiplier fractions remain the same, the excess payments will reduce the balance to which the fractions are applied. A simple example will help clarify these points:

**EXAMPLE** Ms. Ritchie withdraws an eligible amount of $15,000 from her RRSP in July, 2017, and uses the funds for a down payment on a qualifying home. In 2019, a repayment of $2,400 is made and, in 2020, a repayment of $600 is made.

**ANALYSIS** The minimum payment for 2019 is $1,000 [(1/15)($15,000)] and, since this is less than the actual payment, no income inclusion is required. The required payment for 2020 is $900 [(1/14)($15,000 - $2,400)]. As the actual payment is $600, an income inclusion of $300 will be required. This is the case, despite the fact that the

$3,000 in cumulative payments for the two years exceeds the $2,000 minimum that would have been required for the two years. This illustrates the fact that making payments in excess of the required level in one year does not provide an equivalent reduction in the payment for the following year. Note that the required payment for 2021 is also $900 [(1/13)($15,000 - $2,400 - $600 - $300)].

## Exercise Ten - 10

**Subject:** Home Buyers' Plan

During 2017, Ms. Farah DeBoo withdraws $18,000 from her RRSP under the provisions of the Home Buyers' Plan. Due to some unexpected income received during 2018, she repays $5,000 in that year. What is the amount of her minimum repayment during 2019?

**SOLUTION available in print and online Study Guide.**

## Lifelong Learning Plan (LLP)

### General Format

10-114. ITA 146.02 contains provisions that allow an individual to make tax free withdrawals from their RRSPs in order to finance the education of themselves or their spouse or common-law partner. Withdrawals under this Lifelong Learning Plan (LLP) must be repaid over a period of ten years. The repayment amounts are not deductible and, if they are not made as per the required schedule, deficiencies will be included in the individual's income.

### Withdrawals

10-115. To qualify for the tax free withdrawals, the individual or his spouse or common-law partner must be enrolled as a full-time student in a qualifying educational program at a designated educational institution. In general, a qualifying educational program is a post-secondary program that requires students to spend ten hours or more per week on courses that last three consecutive months or more. A designated educational institution is a university, college, or other designated educational institution. See S1-F2-C1, *Education and Textbook Tax Credits*, for more information on designated educational institutions.

10-116. The maximum withdrawal is $10,000 in any one calendar year, to a maximum of $20,000 over a period of up to four calendar years. While the designated person for these withdrawals can be either the individual or his spouse or common-law partner, an individual cannot have a positive LLP balance (withdrawals, less repayments) for more than one person at any point in time. However, both an individual and his spouse or common-law partner can participate at the same time, provided they use funds from their own RRSPs.

10-117. As with HBPs (see Paragraph 10-105), if an RRSP contribution is withdrawn within 90 days as a non-taxable amount under the LLP provisions, it is not deductible in the calculation of the individual's Net Income For Tax Purposes.

### Repayment Of LLP

10-118. Minimum repayments must be made on a straight line basis over a period of ten years. In a manner similar to that used for HBPs, this is accomplished by using a formula in which 1/10 is repaid the first year of repayment, 1/9 the second year, 1/8 the third year, etc. Also in a manner similar to HBPs, deficient repayments will be included in the taxpayer's income and deducted from the outstanding LLP balance. Repayments in excess of the required minimum reduce the balance to which the fractions will be applied but do not change the applicable fraction.

10-119. Any RRSP contribution made during the year, or in the first 60 days of the following year, can be designated an LLP repayment. These designated repayments are not deductible

in the determination of Net Income For Tax Purposes. Repayments must begin no later than the fifth year after the year of the first LLP withdrawal (actually the sixth year if payments are made within 60 days of the end of the fifth year).

**EXAMPLE** Sarah makes LLP withdrawals from 2017 to 2020. She continues in a qualifying education program from 2017 to 2022. Since 2022 is the fifth year after the year of her first LLP withdrawal, Sarah's repayment period is from 2022 to 2031. The due date for her first repayment is no later than March 1, 2023, which is 60 days after the end of 2022, her first repayment year.

10-120. Repayments must begin earlier if the beneficiary of the program does not continue in a qualifying educational program. Specifically, repayment must begin in the second year in which the individual is not enrolled in a qualifying educational program

**EXAMPLE** Joseph makes an LLP withdrawal in 2018 for a qualifying educational program he is enrolled in during 2018. Joseph completes the educational program in 2019. He is not enrolled in a qualifying education program in either 2020 or 2021 and, as a consequence, Joseph's first repayment year is 2021.

### *Other Considerations*

10-121. There is no limit on the number of times an individual can participate in the LLP. However, an individual may not participate in a new plan before the end of the year in which all repayments from any previous participation have been made.

10-122. For a withdrawal to be eligible for tax free status, the designated person must complete the qualified educational program before April of the year following the withdrawal or, alternatively, be enrolled in a qualified educational program at the end of March of the year following the withdrawal. If this is not the case, the withdrawal will still be eligible for tax free treatment, provided less than 75 percent of the tuition paid for the program is refunded.

## Exercise Ten - 11

**Subject:** Lifelong Learning Plan

Jean Paul Riopelle makes a Lifelong Learning Plan (LPP) withdrawal of $5,000 in July, 2017. This is subsequent to his acceptance in a community college art program that runs from September to November, 2017. He completes the course. On February 28 of each year from 2020 through 2029, he makes payments of $500 per year to his RRSP. These amounts are designated as LLP repayments in his tax returns for the years 2019 through 2028. Indicate the tax consequences to Jean Paul of these transactions.

**SOLUTION available in print and online Study Guide.**

## Departure From Canada

### *RRSP Balances*

10-123. ITA 128.1(4)(b) requires a deemed disposition of most capital property when an individual departs from Canada (see coverage of this subject in Chapter 8). However, most pension benefits are exempt from these rules and, as a consequence, a departure from Canada will not automatically result in the collapse of an RRSP.

10-124. Once the taxpayer has ceased to be a resident of Canada, he may find it desirable to collapse the plan. The collapse and subsequent payment to a non-resident will result in taxation under ITA Part XIII. The Part XIII tax is a 25 percent tax on payments to a non-resident and, for those countries with which Canada has a tax treaty, the rate can be as low as 10 percent. Unlike the withholding tax that is assessed on withdrawals by Canadian residents, this is a final tax, and the withdrawn balances will not be subject to further taxation in Canada.

10-125. Whether or not the proceeds resulting from the collapse of the plan will be taxed in the new country of residence will depend on a number of factors, including which country is involved and the manner in which the RRSP income was reported prior to the individual leaving Canada. While there are significant tax planning opportunities in this area, detailed coverage of this subject goes beyond the scope of this text.

10-126. If the plan is not collapsed and payments are made to a non-resident, such payments are also subject to Part XIII tax at a 10 percent, or greater, rate. As was the case with the proceeds resulting from collapsing the plan, how this will be taxed in the individual's new country of residence is determined by a number of factors.

### *Home Buyers' Plan Balances*

10-127. If an individual ceases to be a resident of Canada, any unpaid balance under the HBP must be repaid before the date the tax return for the year of departure should be filed, or 60 days after becoming a non-resident, whichever date is earlier. If this deadline is not met, the unpaid balance must be included in income.

### *Lifelong Learning Plan Balances*

10-128. Similar to the provisions under the HBP, if an individual ceases to be a resident of Canada, any unpaid balance under the LLP must be repaid before the date the tax return for the year of departure should be filed, or 60 days after becoming a non-resident, whichever date is earlier. If this deadline is not met, the unpaid balance must be included in income.

## Death Of The RRSP Registrant

### *General Rules*

10-129. When an individual dies, there can be many tax implications. In this Chapter 10, we will cover the complications associated with RRSPs owned by an individual at the time of death.

10-130. The general rules for RRSPs depend on whether the plan is an unmatured plan (i.e., the registrant has not converted the plan to an annuity) or a matured plan (i.e., the plan has been converted to an annuity which is producing a regular stream of income). As described in RC4177, "Death Of An RRSP Annuitant", the general rules are as follows:

> **Unmatured RRSPs** When the registrant of an unmatured RRSP dies, he or she is considered to have received, immediately before death, an amount equal to the fair market value of all the property held in the RRSP at the time of death. This amount, and all other amounts the registrant received in the year from the RRSP, have to be reported on the registrant's return for the year of death.
>
> **Matured RRSPs** When the annuitant of a matured RRSP dies, the annuitant is considered to have received, immediately before death, an amount equal to the fair market value of all remaining annuity payments under the RRSP at the time of death. This amount, and all other amounts the annuitant received in the year from the RRSP, have to be reported on the annuitant's return for the year of death. Note that, if a straight life annuity was involved, there would be no further payments after death.

10-131. If these general rules are applied, with the lump-sum or annuity amounts included in the decedent's final tax return, the assets will pass to the specified beneficiaries at fair market value, with no immediate tax consequences for the beneficiaries. However, when the RRSP assets or annuity are transferred to certain qualified beneficiaries, there are important exceptions to this general rule. (See material which follows.)

10-132. An additional point here is that there are two different ways in which RRSP assets can be transferred at death. The preferable approach is for the registrant to specify the beneficiary, or beneficiaries, in the RRSP contract. This will result in the assets being passed immediately at death. Perhaps more importantly, probate fees will be avoided.

10-133. If this approach is not used, the RRSP assets will pass into the deceased's estate. If this happens, their distribution will be subject to probate fees. In Ontario, these fees are 0.5 percent of the first $50,000, plus 1.5 percent of any amount in excess of $50,000.

### Exception - Transfers To A Spouse Or Common-Law Partner

10-134. The various possibilities that could arise when the disposition of an RRSP after death is to a spouse or common-law partner can be described as follows:

**Unmatured RRSP - Spouse Is Beneficiary** If the spouse is the sole beneficiary and there is a transfer to an RRSP with the spouse as the registrant, there will be no tax consequences for either the decedent or the spouse. The assets in the decedent's RRSP simply become assets in the spouse's RRSP. This is usually the most tax advantageous arrangement for dealing with an unmatured RRSP.

**Matured RRSP - Spouse Is Beneficiary** If the RRSP is in the form of an annuity with the spouse as the sole beneficiary, the RRSP will continue with the spouse receiving the payments. There will be no tax consequences for the decedent and the spouse will be taxed as the annuity payments are received. For matured RRSPs, this is clearly the most tax advantageous arrangement.

**Estate Is Beneficiary** Whether the RRSP has or has not matured, the general rules will be applicable here. If the spouse is the beneficiary of the estate, the same rollover results can be achieved here through the use of elections. However, probate fees will be applicable and the procedures will be more complex.

### Exception - Transfers To A Financially Dependent Child Or Grandchild

10-135. Without becoming involved in the details, there are provisions that allow both matured and unmatured RRSPs to be transferred to a financially dependent child or grandchild on a basis that shifts the tax burden from the decedent to the transferee.

10-136. While the relevant amounts could be taxed in the hands of the dependant, there are other options. If the child has a physical or mental infirmity, the dependant can avoid current taxation by transferring the amounts to an RRSP, RRIF, Registered Disability Savings Plan (RDSP as described in Chapter 9) or an annuity. If there is no physical or mental infirmity, the only option that avoids current taxation is to purchase an annuity. In this case, the life of the annuity cannot exceed 18 years, minus the age of the child or grandchild when the annuity is purchased. As a result, if the child is over 17 years of age, this option cannot be used.

### Home Buyers' Plan Balances

10-137. If a participant in the HBP dies prior to repaying all amounts to the RRSP, any unpaid balance will be included in income in the final tax return. However, a surviving spouse may elect with the legal representatives of the deceased to avoid the income inclusion. If this election is made, the surviving spouse assumes the position of the deceased by being treated as having received an eligible amount equal to the unpaid balance outstanding at the time of the deceased's death. This amount is added to any balance of eligible amounts received by the surviving spouse that have not been previously repaid to the RRSPs.

### Lifelong Learning Plan Balances

10-138. If an individual dies and has a positive LLP balance, this balance must be included in the individual's income for the year of death. As is the case with HBPs, there is an election that allows a spouse to make the repayments under the deceased's LLP terms.

**We suggest you work Self Study Problem Ten-6 at this point.**

# Registered Pension Plans (RPPs)

## Establishing An RPP

### Types Of Plans

10-139. The most important type of Canadian pension arrangement is the Registered Pension Plan (RPP) provided by some employers for their employees. Such plans are established by a contract between the employer and the employees and provide either for a pension benefit that is determined under a prescribed formula (a defined benefit or benefit based plan), or for a specified annual contribution by the employer that will provide a benefit that will be based on the funds available at the time of retirement (a money purchase or contribution based plan).

10-140. An additional variable is the question of whether, in addition to the contributions made by the employer, the employees make contributions to the plan. If they do, it is referred to as a contributory plan. Both employer and employee contributions to the RPPs are normally deposited with a trustee who is responsible for safeguarding and managing the funds deposited.

### Registration Of The Plan

10-141. It would be possible for an employer to have a pension plan that is not registered. However, such an arrangement would make very little sense. In order to deduct contributions for tax purposes, an employer sponsored pension plan must be registered with the CRA.

10-142. In most situations, the basic requirements for registration are not difficult to meet. The plan must provide a definite arrangement, established as a continuing policy by an employer, under which benefits are provided to employees after their retirement. The terms and conditions must be set out in writing and the amounts of benefits to be provided must be reasonable in the circumstances.

## Employer Contributions To The RPP

### General Rules

10-143. As is noted in Chapter 6 on business income, ITA 20(1)(q) allows an employer to deduct contributions to an RPP in the determination of Net Income For Tax Purposes. It indicates that such amounts can be deducted to the extent that they are provided for by ITA 147.2(1) or 147.5(10).

10-144. Turning to these subsections, we find that contributions to money purchase plans are deductible as long as they are made in accordance with the plan as registered. For defined benefit plans there is a similar requirement. Contributions made during the year, or within 120 days after the year end, are deductible as long as they have not been deducted previously.

10-145. Note that the reference is to contributions made, establishing the fact that the availability of deductions for pension costs is on a cash basis. As deductions under GAAP must be determined on an accrual basis, there are likely to be differences between the accounting expense for the period and the tax deduction for the period.

### Restrictions

10-146. The preceding general rules appear to provide for any level of deductions, as long as the amount is consistent with the plan as registered. As we have noted, however, the restrictions on contributions are implemented through the registration process. More specifically, ITA 147.1(8) indicates that RPPs become revocable if the PA of a member of the plan exceeds the lesser of:

- the money purchase limit for the year, and
- 18 percent of the member's compensation from the employer for the year.

10-147. Given the fact that the RRSP Deduction Limit is also based on these same factors (with a one year lag), this restriction means that, in general, an RPP cannot provide for more

retirement savings than would be available to an individual whose only retirement savings vehicle is an RRSP. To illustrate this, consider a member of a money purchase RPP who always has employment income in excess of $200,000. As 18 percent of this individual's income will always be larger than the money purchase limit, his maximum retirement savings will be determined by that limit. This means that for 2019, his limit will be $27,230.

10-148. If that same individual was not a member of an RPP, his maximum retirement savings would be based on the RRSP dollar limit, a figure that lags the money purchase limit by one year. Given this, his 2019 maximum retirement savings would be $26,500, $730 less than would be the case if he were a member of an RPP.

10-149. An RPP that provides benefits to an employee that creates a PA in excess of the money purchase limit for the year, or 18 percent of the employee's compensation, will have its registration revoked. Given that registration is required for RPP contributions to be deductible, this requirement should ensure that benefits are limited to the specified levels.

10-150. Before leaving this discussion of employer contributions, you should note that this restriction on PAs would effectively restrict both employer and employee contributions to an RPP. Both types of contributions go into the PA calculation and, as a consequence, placing the limit on this measure of pension benefits ensures that the combined employee/employer contributions will be restricted to the desired maximum level.

## Employee Contributions To The RPP

10-151. As is noted in Chapter 3, the basic provision here is ITA 8(1)(m) which indicates that, in the determination of employment income, individuals can deduct contributions to an employer's RPP as specified in ITA 147.2(4). Taking the same approach that was used for employer contributions, this Subsection indicates that amounts contributed for current service are deductible if they are made in accordance with the terms of the plan. This places employee contributions under the same overall limit as employer contributions. That is, they must be made under the terms of a plan that does not produce a PA that exceeds the lesser of the money purchase limit for the year and 18 percent of the employee's compensation for the year.

## Options At Retirement

10-152. Retirement options for RPPs are not established in tax legislation. Each employer sponsored plan has a set of rules that are applicable to the participants of that plan. Most plans only allow the individual to receive the periodic benefit to which he or she is entitled. Less frequently, some plans may allow for a lump sum withdrawal, a transfer to a different type of plan, or a transfer to another employer's plan. Transfers to other plans are discussed beginning in Paragraph 10-197.

## Phased Retirement

### *The Problem*

10-153. At one time, an employee could not accrue benefits under a defined benefit RPP if he was currently receiving benefits from that plan. This prohibition also applied if the employee was receiving benefits from another defined benefit RPP sponsored by the same employer or an employer related to that employer. This meant that:

- If an individual had wanted to phase in retirement by working on a part time basis after he had started to receive his basic pension benefits, he could not receive any further pension benefits for this part time work.
- If an individual continued on a full time basis after beginning to receive his basic pension benefit, he could not be rewarded with a partial pension benefit for this additional work.

### The Solution

10-154. The problem has been dealt with in ITR 8503(16) through (25). An employer can pay employees up to 60 percent of their accrued defined benefit pension entitlement, while they continue to accrue additional pension benefits on a current service basis with respect to their post-pension commencement employment. This program is limited to employees who are at least 55 years of age and who are otherwise eligible to receive a pension without being subject to an early retirement reduction.

## Inadequate Retirement Savings

### The Problem

10-155. It is very clear that a large majority of Canadian individuals are not making adequate financial arrangements for their retirement years. While this is not a problem for those fortunate individuals who are members of a generous RPP sponsored by a government organization, a large public company, or a large union, there are many other individuals who will be facing a bleak future once their working years have ended.

10-156. To some extent, RRSPs provide a solution to this problem. However, it appears that Canadians are not making effective use of these plans. In 2016, only 22.5 percent of tax filers made contributions to these plans, down from 29 percent in 2000. The actual number of contributors was only 6 million, a number that has remained virtually unchanged since 2009. Further, the average contribution was only $3,000, leaving billion of dollars in unused deduction room on the table. Clearly, RRSPs, which rely on voluntary contributions by registrants, will not solve the problem of inadequate retirement savings.

10-157. An obvious solution to these problems is to have a larger percentage of Canadians enrolled in plans that require regular contributions. RPPs sponsored by a single employer are not likely to provide a general solution to this problem as the maintenance of a registered pension plan is very expensive. This makes it difficult for small or even medium sized employers to provide an RPP. Further, RRSPs do not provide a totally satisfactory solution in that the size of these individual plans is not sufficient to justify the cost of either professional management or adequate diversification of assets.

### Pooled Registered Pension Plans (PRPPs)

10-158. One proposed solution to the problem of inadequate retirement savings is what the government refers to as Pooled Registered Pension Plans (PRPPs). These are, in effect, registered pension plans offered and managed by financial institutions such as trust and insurance companies. The basic features of these plans can be described as follows:

- These are money purchase plans sponsored by a financial institution capable of taking on a fiduciary role (trust and insurance companies). The sponsoring financial institutions are the administrators of the plan. They are responsible for receiving contributions, thereby creating a large pool of capital that can be used to construct asset portfolios designed to appeal to various potential registrants. They are also responsible for complying with tax rules, particularly with respect to administrative and reporting requirements related to contributions and withdrawals.
- An employer can select a particular plan for its employees. While the financial institution retains primary responsibility for the management of the plan, the employer would be responsible for enrolling its employees in the plan, determining the level of contributions, and collecting contributions to the plan. There is no requirement that the employer would have to make contributions to the plan and employees can opt out of participating.
- In addition to employed members, individual members who are either employees of employers who choose not to participate in a PRPP or are self-employed individuals can also participate in PRPPs.

- Without going into detail, the PRPPs operate under the general rules applicable to all types of retirement savings (e.g., contributions cannot exceed the annual money purchase limits and there will be penalties for excess contributions).
- The plans will generally be portable, with members being able to move the benefits they've accrued to another plan or retirement savings vehicle.
- The PRPP legislation allows interested jurisdictions to require mandatory participation for employers.

10-159. It is hoped that the introduction of PRPPs will result in a large increase in the number of individuals that participate in a registered pension plan that requires regular contributions. While regulations for the operation of PRPPs have been issued at the federal level, additional legislation is required in each province. At this time, legislation is in place in Alberta, British Columbia, Manitoba, Nova Scotia, Ontario, Quebec, and Saskatchewan.

### Target Benefit Plans

10-160. A different solution to the problem of inadequate retirement savings has been proposed by the federal government. Target benefit plans, a.k.a. shared risk plans are something of a compromise between defined contribution plans and defined benefit plans:

- Like defined contribution plans, target benefit plans have either fixed contribution rates or, in some cases, contribution rates that vary within a narrow range.
- Like defined benefit plans, target benefit plans have a targeted pension benefit.
- The compromise is that, unlike a regular defined benefit plan, target benefit plans allow for benefits to be reduced if the fund assets are not sufficient to provide the targeted benefit.

10-161. At this point, several provinces have introduced legislation to provide for plans with these characteristics. While target benefit plans may become widespread in the future, they are not currently of sufficient importance to cover in this general text.

### Expanded Canada Pension Plan

10-162. It is a fact that, given current levels of retirement savings, many individuals will find themselves in a very difficult financial situation in their retirement years. It is clear that the existing retirement savings programs are not capable of coping with this large scale problem. The portion of workers who are members of an employer sponsored RPP is declining and the generous provisions of the RRSP legislation are not being used in anything approaching an adequate fashion. In addition, for various reasons, expected life spans are getting longer.

10-163. Like the existing programs, pooled registered pension plans and target benefit plans require the participation of employers or voluntary actions by the plan participants. It is unlikely that these programs will fully solve what is becoming an increasingly urgent problem.

10-164. Unlike other retirement savings vehicles, the CPP is not an optional program. If you have employment income, you and your employer must participate. If you have business income as an individual, you are also required to participate.

10-165. The problem, however, is the adequacy of the benefits that are provided under this program. The maximum benefit is currently just of over $13,900. Even when this is combined with the OAS payment of just over $7,400, the combined total comes to an amount that is just above what is considered a poverty level of income.

10-166. In the U.S., the Social Security system is a similar system to the CPP (required participation by employers and individuals earning business income). In contrast to the low benefits provided under the CPP program, the maximum benefit in the U.S. for an individual retiring at age 65 is over US$33,000 per year. If Canadians wish to enjoy a more financially secure retirement, CPP benefits must move closer to the amounts paid in the U.S.

10-167. It appears that this will happen. Up until 2019, the CPP retirement pension is designed to replace one-quarter of average work earnings. Under a new agreement

negotiated with the provinces, it is expected that, during the period 2019 through 2025, the benefit will increase to one-third of average work earnings. This will result in a maximum benefit of around $30,000 per year. The anticipated changes will require an increase in both the maximum insurable earnings and the contribution rate.

# Registered Retirement Income Funds (RRIFs)

## Establishment

### *Only Transfers From Other Plans*

10-168. A RRIF is a trusteed arrangement, administered in much the same manner as an RRSP. A basic difference, however, is the fact that deductible contributions cannot be made to a RRIF. ITA 146.3(2)(f) makes it clear that the only types of property that can be accepted by the RRIF trustee are transfers from other types of retirement savings arrangements. The most common type of transfer would be the tax free rollover that can be made from an RRSP. As was indicated previously, this commonly occurs when an individual reaches age 71 and can no longer maintain an RRSP.

10-169. There is no limit on the number of RRIFs that can be owned by a taxpayer and, in addition, the taxpayer has complete flexibility as to the number of RRSPs that can be transferred to a RRIF on a tax free basis. Further, the taxpayer is free to divide any RRSP and only transfer a portion of the funds to a RRIF. This in no way limits the options available for any remaining balance from the RRSP.

10-170. A RRIF can be established by an individual of any age and without regard to whether the individual is retiring. However, the individual must have an eligible savings plan, such as an RRSP, from which funds can be transferred.

### *Other Considerations*

10-171. Any amount transferred from an RRSP to a RRIF is not subject to taxation until it is withdrawn by the taxpayer from the RRIF. As was the case with RRSPs, withdrawals are taxed as ordinary income, without regard to how they were earned inside the RRIF (e.g., capital gains realized within the RRIF are taxed in full on withdrawal from the plan).

10-172. Once inside the RRIF, the assets can be managed by the trustee of the plan according to the directions of the taxpayer. The list of qualified investments for RRIFs is similar to that for RRSPs and allows for considerable latitude in investment policies. As is the case with RRSPs, fees paid by an individual for the administration of a RRIF are not deductible.

## RRIF Withdrawals

### *Pension Income Tax Credit And Pension Income Splitting*

10-173. In our discussion of RRSP withdrawals, we noted that lump sum withdrawals from RRSPs are not eligible for the pension income tax credit or the pension income splitting provision. Fortunately, this is not the case with lump sum withdrawals from a RRIF. If the taxpayer is aged 65 or over, all taxable withdrawals from a RRIF qualify for the pension income tax credit and can be split with a spouse or common-law partner.

### *Withdrawals Greater Than The Minimum Withdrawal*

10-174. While legislation establishes the minimum withdrawal from a RRIF (see the following paragraph), there is no maximum withdrawal. The entire balance in the RRIF can be withdrawn at any time. However, as was noted, any amounts removed from the RRIF must be included in Net Income For Tax Purposes in the year of withdrawal. In contrast to RRSPs where tax is withheld on any regular withdrawals, tax is only withheld on RRIF withdrawals in excess of the minimum withdrawal.

### *Calculating The Amount Of The Minimum Withdrawal*

10-175. We noted previously that, unlike the situation with RRSPs, an individual cannot

make deductible contributions to a RRIF. Another difference between an RRSP and a RRIF is that a minimum annual withdrawal must be made from a RRIF beginning in the year following the year it is established.

10-176. For an individual who is under 71 at the beginning of the year, the minimum withdrawal is determined by dividing the fair market value of the RRIF assets at the beginning of the year, by 90 minus the age of the individual at the beginning of the year.

10-177. If an individual is 71 years of age or older at the beginning of the year, the amount that must be withdrawn is determined by a prescribed percentage applied to the RRIF assets at the beginning of the year. This percentage is found in ITR 7308(4). It increases each year starting at 5.28 percent for an individual who is 71 years old at the beginning of the year, until it reaches 20 percent for individuals who are aged 95 at the beginning of the year. It remains at 20 percent for each subsequent year until the individual dies. This, of course, means that the RRIF balance will never reach zero if minimum withdrawals are made.

**EXAMPLE** Moira established her RRIF in 2016. At the beginning of 2018 she was 70 years old and had $1,000,000 in RRIF assets. At the beginning of 2019 she had $980,000 in RRIF assets.

**ANALYSIS** Moira's minimum RRIF withdrawal would be $50,000 [$1,000,000 ÷ (90 - 70)] for 2018 and $51,744 [($980,000)(5.28%)] for 2019.

### *Use Of Spouse's Age For Minimum Withdrawal*

10-178. It is possible to irrevocably elect to use a spouse's age to calculate the minimum RRIF withdrawal. If the spouse is younger, the minimum amount is lower and offers an opportunity to defer the tax effect of the withdrawals.

## Exercise Ten - 12

**Subject:** Minimum RRIF Withdrawal

On January 1, 2019, Mr. Larry Harold transfers all of his RRSP funds into a RRIF. Mr. Harold is 65 years old on that date. The fair market value of these assets on January 1, 2019 is $625,000. The corresponding figure on January 1, 2020 is $660,000. What is the minimum withdrawal that Mr. Harold must make from the RRIF during 2019 and during 2020?

**SOLUTION available in print and online Study Guide.**

## Death Of The RRIF Registrant

### *General Rules*

10-179. As was the case with an RRSP, the general rule is that, when a taxpayer dies, the fair market value of the assets in his RRIF will be included as income in his final tax return. Also following this pattern, there are exceptions when the RRIF is transferred to either a spouse or common-law partner, or a financially dependent child or grandchild of the taxpayer.

### *Rollovers*

10-180. If an individual has a spouse or common-law partner, the most tax advantageous approach to estate planning is usually to name that person as the successor registrant of the RRIF. In this situation, the RRIF will simply continue with the surviving spouse receiving the payments. There will be no tax consequences for the decedent and future withdrawals from the RRIF will be taxed in the hands of the spouse.

10-181. If a RRIF is left to the decedent's estate, the alternatives for transfers to a spouse or common-law partner, or to a financially dependent child or grandchild, are the same as those for an RRSP (see Paragraphs 10-134 to 10-136).

10-182. As was the case with RRSPs, a tax free rollover to a spouse or common-law partner is available by making appropriate elections. Also as with RRSPs, if a financially dependent child or grandchild is physically or mentally infirm, current taxation can be avoided if the assets are transferred to an RRSP, a RRIF, a RDSP, or an annuity. In the absence of a physical or mental infirmity, the only option is the purchase of a limited term annuity.

## Evaluation Of RRIFs

10-183. For individuals required by age to terminate their RRSP, lump sum withdrawals are usually not a good choice. This reflects the fact that such withdrawals can often result in a large portion of the income being taxed at high rates. In addition, the pension income splitting provisions cannot be utilized. A possible exception to this view would be situations in which the taxpayer plans to give up Canadian residency.

10-184. This leaves individuals with a choice between using a RRIF and purchasing an annuity. The fact that life annuities are only available through life insurance companies means that the rates of return implicit in these financial instruments are often not competitive with other investments.

10-185. Further, annuities lack flexibility. Once an individual has entered into an annuity contract, there is usually no possibility of acquiring larger payments if they are required by some unforeseen event. In contrast, RRIFs offer some degree of flexibility with respect to amounts available to the taxpayer.

10-186. As a final point, the wide range of qualifying investments that can be acquired in RRIFs provide individuals with the opportunity to achieve better rates of return than those available through the purchase of annuities. It would appear that, for most individuals, the use of a RRIF is the most desirable option when the individual's age forces the collapse of an RRSP.

# Deferred Profit Sharing Plans

## General Rules

10-187. ITA 147 provides for an arrangement where an employer can deduct contributions made to a trustee of a Deferred Profit Sharing Plan (DPSP, hereafter) for the benefit of the employees. Employees cannot make contributions to an employer sponsored DPSP. However, certain direct transfers of balances from other plans belonging to the employee can be made (see Paragraph 10-197).

10-188. Amounts placed in the plan will be invested, with investment earnings accruing on a tax fee basis. As with the other retirement savings vehicles, the beneficiary of the plan is taxed only when assets are distributed from the plan.

10-189. As was the case with RPPs, the employer's contributions to these plans are limited by a maximum PA that must be complied with to avoid having the DPSP revoked. This is found in ITA 147(5.1) and is more restrictive than the corresponding limit for RPPs. Like the situation with RPPs, contributions to DPSPs cannot result in a PA that exceeds 18 percent of a beneficiary's employment income for the year. However, contributions to these plans are limited to only one-half of the money purchase limit for the year.

## Tax Planning

10-190. From the point of view of the employer, DPSPs are similar to RPPs. However, they have the advantage of providing greater flexibility in the scheduling of payments. Such plans are tied to the profits of the business and, if the business has a bad year, it will normally result in a reduction of payments into the DPSP. Further, no specific benefits are promised to the employees. This relieves the employer from any responsibility for bad investment decisions by the fund trustee or estimation errors in the actuarial valuation process, factors that can cause significant uncertainty for the sponsors of defined benefit RPPs.

10-191. From the point of view of the employee, a DPSP operates in a manner similar to an RPP. The major difference is that employees are not permitted to contribute to DPSPs. A further difference is that DPSPs cannot be designed to provide a defined benefit. They are always defined contribution plans.

10-192. DPSPs must invest in certain qualified investments and there are penalties for purchases of non-qualified investments. A final important consideration is that DPSPs cannot be registered if the employer or a member of the employer's family is a beneficiary under the plan. This would include major shareholders if the employer is a corporation, individual owners if the employer is a proprietorship or partnership, and beneficiaries when the employer is a trust.

# Profit Sharing Plans

## General Rules

10-193. ITA 144 provides for Profit Sharing Plans. These plans are similar to DPSPs in that the employer can deduct contributions made on behalf of employees. Unlike the DPSPs, there are no specified limits on the employer's contributions as long as they are reasonable and are paid out of profits.

10-194. However, these plans have not achieved the popularity of DPSPs for a very simple reason. The employer's contributions to Profit Sharing Plans are taxable income to the employee in the year in which they are made. In addition, any income that accrues on the assets in the fund is allocated to the employee as it accrues. Although payments to the employees out of the fund are received on a tax free basis, this form of compensation offers no deferral of tax and requires the payment of taxes on amounts that have not been realized by the employee. Given these facts, it is not surprising that such Profit Sharing Plans have not been a popular compensation mechanism.

## Part XI.4 Tax On Excess PSP Contributions

10-195. The preceding suggests that there are not really any tax advantages associated with the use of Profit Sharing Plans. However, the CRA has found that such plans are being used:

- to direct business profits to family members in order to reduce taxes; and
- to avoid employee withholding requirements, as well as CPP and EI payments.

10-196. To curtail these practices, there is a Part XI.4 tax on excess contributions for specified employees. A "specified employee" is defined in ITA 248(1) as a person who is a specified shareholder of the employer, or who does not deal at arm's length with the employer. The tax is assessed on amounts paid by the employer into the profit sharing plan for the benefit of a specified employee that exceed 20 percent of that individual's employment income for the year. It will be assessed at the maximum federal/provincial rate applicable to individuals in their province of residence.

# Transfers Between Plans

## Accumulated Benefits

10-197. As individuals may belong to several different retirement savings plans over their working lives, it is important that tax free transfers between different types of retirement savings plans can be made. For example, an individual who goes from a position where the employer provides RPP benefits, to a different position where no such benefits are provided, may wish to have his accumulated RPP benefits transferred to his RRSP. In the absence of a special provision to deal with this transfer, the benefits transferred from the RPP would have to be included in the individual's Net Income For Tax Purposes in the year of withdrawal. This, of course, would make such a transfer very unattractive.

10-198. Fortunately, the *Act* allows for great flexibility in this area. Provided the transfer is made directly between the plans, the following transfers can be made on a tax free basis:

**Registered Pension Plans** ITA 147.3 provides for the direct transfer of a lump sum amount from an RPP to a different RPP, to an RRSP, and to a RRIF. The Section also permits a transfer from a taxpayer's RPP to an RPP, RRSP, or RRIF of his or her spouse, former spouse, common-law partner or former common-law partner under a court order or written separation agreement in the event of a marriage or common-law partnership breakdown.

**Registered Retirement Savings Plans** ITA 146(16) provides for the transfer of lump sum amounts from an RRSP to a RRIF, an RPP, or to another RRSP. The Subsection also permits a transfer from a taxpayer's RRSP to an RRSP or RRIF of his or her spouse, former spouse, common-law partner or former common-law partner under a court order or written separation agreement in the event of a marriage or common-law partnership breakdown.

**Deferred Profit Sharing Plans** ITA 147(19) provides for the direct transfer of a lump sum amount from a DPSP to an RPP, an RRSP, or to a different DPSP. There are additional tax free transfers to the taxpayer's RRIF and to an RPP, RRSP, DPSP or RRIF of his or her spouse, former spouse, common-law partner or former common-law partner under a court order or written separation agreement in the event of a marriage or common-law partnership breakdown.

## Retiring Allowances

10-199. The full amount of any retiring allowance, which includes amounts received for loss of office or employment and unused sick leave, must be included in the taxpayer's income in the year received. Employees who have worked for the same employer for a long time can take advantage of a deduction available under ITA 60(j.1) for certain amounts transferred to either an RPP or an RRSP. This, in effect, creates a tax free transfer of all, or part, of a retiring allowance into an RRSP, without using up any of the available RRSP deduction room. The limit on this tax free transfer is as follows:

- $2,000 for each year, or part year, the taxpayer was employed by the employer prior to 1996. This includes non-continuous service with the same employer.
- An additional $1,500 for each year, or part year, the taxpayer was employed by the employer prior to 1989 for which the employer's contributions to an RPP or DPSP had not vested by the time the retiring allowance was paid.

10-200. This transfer does not have to be directly from the employer to the RRSP. The deduction is available if the taxpayer receives the funds and deposits the eligible amount into his RRSP within 60 days of the end of the year it is received. The eligible amount must be contributed to the employee's RRSP (not a spousal RRSP) to be deducted. However, if a direct transfer is used, the taxpayer will avoid having income tax withheld on the retiring allowance. It should also be noted that, for the individual to deduct the amount transferred to his RRSP, the trustee must issue the usual RRSP contribution receipt.

**EXAMPLE** Joan Marx retires at the end of 2019, receiving from her employer a retiring allowance of $150,000. She began working for this employer in 1982. The employer has never sponsored an RPP or a DPSP.

**ANALYSIS** The entire $150,000 must be included in Ms. Marx's 2019 Net Income For Tax Purposes. Provided she makes a $38,500 [($2,000)(the 14 years 1982 through 1995) + ($1,500)(the 7 years 1982 through 1988)] contribution to her RRSP, she will be able to deduct the $38,500 RRSP contribution, without eroding her RRSP deduction room.

### Exercise Ten - 13

**Subject:** Retiring Allowance

On December, 31, 2019, Mr. Giovanni Bartoli retires after 44 years of service with his present employer. In recognition of his outstanding service during these years, his employer pays him a retiring allowance of $100,000. His employer has never sponsored an RPP or a DPSP. What is the maximum deductible contribution that Mr. Bartoli can make to his RRSP as a result of receiving this retiring allowance?

**SOLUTION available in print and online Study Guide.**

**We suggest you work Self Study Problems Ten-7 at this point.**

# Retirement Compensation Arrangements

## The Problem

10-201. As we have seen throughout this Chapter, the rules related to maximum contributions by employers to RPPs and DPSPs are very specific. While these maximum limits are sufficient to provide a reasonable level of retirement income to the majority of employees, they fall short of this goal for highly paid senior executives. Such individuals are often accustomed to a lifestyle that cannot be sustained by the maximum amounts that can be produced by RPPs and DPSPs. A similar analysis can be made for owner/managers of successful private corporations.

10-202. Given this situation, both public and private corporations use plans other than RPPs and DPSPs to provide benefits that are not limited by the rules applicable to the more conventional plans. In general, such arrangements can be classified as Retirement Compensation Arrangements (RCAs).

## Arrangements Defined

10-203. RCAs are defined in the *Income Tax Act* as follows:

> **ITA 248(1) Retirement compensation arrangement** means a plan or arrangement under which contributions are made by an employer or former employer of a taxpayer, or by a person with whom the employer or former employer does not deal at arm's length, to another person or partnership in connection with benefits that are to be received or may be received or enjoyed by any person on, after, or in contemplation of any substantial change in the services rendered by the taxpayer, the retirement of the taxpayer or the loss of an office or employment of the taxpayer.

10-204. The definition goes on to indicate that the term retirement compensation arrangement does not include RPPs, PRPPs, DPSPs, RRSPs, profit sharing plans, supplementary unemployment benefit plans, or plans established for the purpose of deferring the salary or wages of a professional athlete.

10-205. Provided the arrangement involves a contractual obligation to ultimately make payments to the covered employees, a corporation's contributions to a RCA are fully deductible when made. However, as we shall see in the following material, both contributions and subsequent earnings on the invested contributions are subject to a special refundable tax.

## Part XI.3 Refundable Tax

10-206. Contributions made to a RCA are subject to a 50 percent refundable tax under ITA Part XI.3. In addition, earnings on the assets contained in the plan are subject to this same 50

percent refundable tax. The tax amounts are refunded at a 50 percent rate when distributions are made to the beneficiaries of the plan.

**EXAMPLE** During 2018, Borscan Ltd. contributes $50,000 to a plan established for several of its senior executives. The funds are used to purchase investments that earn interest of $4,500, and no payments are made to the executives during the year. On January 1, 2019, $20,000 is distributed to the beneficiaries of the plan.

**ANALYSIS** Borscan Ltd. would be able to deduct the $50,000 payment into the plan in determining its 2018 Net Income For Tax Purposes. However, the Company would be required to pay Part XI.3 tax of $27,250 [(50%)($50,000 + $4,500)]. In 2019, when the $20,000 distribution is made to the beneficiaries, the Company would receive a refund of $10,000 [(50%)($20,000)].

10-207. In legislating this tax provision, it was clearly the intent of the government to discourage the use of RCAs. The 50 percent tax that is required at the corporate level is higher, in some provinces significantly so, than the rate that would be paid by an individual if the equivalent funds were simply distributed as salary.

10-208. As a result, this means that more taxes will be paid initially, in situations where a RCA is used to compensate employees. Although the Part XI.3 tax is totally refundable, the corporation will not receive any refund of the tax until distributions from the RCA are made.

10-209. Despite this analysis, the use of RCAs appears to be on the rise, particularly with respect to providing retirement benefits to the owner/managers of private corporations. The explanation for this phenomenon probably lies in the not always rational preference that such owner/managers have for having taxation occur at the corporate, rather than the personal level.

10-210. In addition, it appears that the CRA has discovered the use of "tax motivated arrangements" that are perceived to be an abuse of the retirement compensation arrangement rules. These arrangements are very technical and covering them goes beyond the scope of this text. However, we would note that there are a number of special rules which assess penalties in some situations where retirement compensation arrangements are established between non-arm's length parties.

# Salary Deferral Arrangements

## The Problem

10-211. The fact that business income is on an accrual basis while employment income is on a cash basis has made it advantageous for employers to accrue bonuses prior to the actual payment of the amount to the employee. As was discussed in Chapter 3, if payment to the employee is made within 180 days of the employer's year end, the employer can deduct the amount when accrued, while the employee will not be taxed until the bonus is paid.

10-212. If, however, the actual payment occurs more than 180 days after the employer's year end, ITA 78(4) defers the deductibility of the bonus until the point in time when it is actually paid. However, even if the employer cannot deduct the amounts until they are paid, it may still be attractive to make an arrangement that will defer compensation and postpone the payment of taxes by the employee. The concept of a salary deferral arrangement serves to place a time limit on the ability of employers and employees to make such arrangements.

## The Solution

10-213. The *Act* defines a salary deferral arrangement as follows:

**ITA 248(1) Salary deferral arrangement** A plan or arrangement, whether funded or not, under which any person has a right in a taxation year to receive an amount after the year where it is reasonable to consider that one of the main purposes for the creation or existence of the right is to postpone tax payable under this Act by the taxpayer in respect of an amount that is, or is on account or in lieu of, salary or wages

> of the taxpayer for services rendered by the taxpayer in the year or a preceding taxation year (including such a right that is subject to one or more conditions unless there is a substantial risk that any one of those conditions will not be satisfied).

10-214. Converting this to everyday terms, a salary deferral arrangement involves an amount of salary that has been earned by an individual during the taxation year. However, the employee has made an arrangement with his employer to defer the actual receipt of the amount with the intent of postponing the payment of taxes.

10-215. The definition of a salary deferral arrangement also contains a number of exclusions from its scope. These include RPPs, DPSPs, profit sharing plans, supplementary unemployment benefit plans, plans for providing education or training (sabbaticals), or plans established for the purpose of deferring the salary of a professional athlete.

10-216. A further important exception is that the definition of a salary deferral arrangement excludes bonus arrangements where the amount is paid within three years of the end of the calendar year in which the employee provided his services. This means that the ITA 78(4) rules deferring deductibility by the employer apply to amounts that are paid more than 180 days after the employer's year end, but within three years of the end of the calendar year in which the services were rendered. If the payment is beyond three years, it is subject to the salary deferral arrangement rules.

10-217. Under the salary deferral arrangement rules, employers deduct amounts that fall within this definition in the fiscal year the bonus is declared and employees cannot defer taxation on these amounts. They are required to include such amounts in their Net Income For Tax Purposes on an accrual basis, rather than on the cash basis that is the normal basis for employment income. In many cases, this will serve to remove any tax incentive from this type of arrangement and will discourage their continued use.

10-218. Despite these restrictions, certain deferral arrangements can be effective in that they do not fall within the ITA 248(1) definition. These include:

- self funded leave of absence arrangements (sabbaticals);
- bonus arrangements with payment deferred not more than three years, provided the employer accepts the loss of deductibility that occurs after 180 days;
- deferred compensation for professional athletes; and
- retiring allowances. (These escape the salary deferral arrangement rules and, within limits, can be transferred on a tax free basis to an RRSP as discussed in Paragraph 10-199.)

# Individual Pension Plans (IPPs)

10-219. It is possible to establish a defined benefit plan for a single individual. These plans are defined in ITR 8300(1) as follows:

> ... a registered pension plan that contains a defined benefit provision if, at any time in the year or a preceding year, the plan has fewer than four members and at least one of them is related to a participating employer in the plan.

10-220. Such plans are usually marketed in conjunction with insurance products and their establishment requires the use of an actuarial valuation for the specific individual covered by the plan.

10-221. These plans have grown in popularity in recent years, particularly for successful owner/managers of private companies. However, the actuarial concepts involved in these plans go beyond the scope of this text. As a consequence, we will not provide detailed coverage of these specialized arrangements.

**We suggest you work Self Study Problems Ten-8 and Ten-9 at this point.**

**Additional Supplementary Self Study Problems Are Available Online.**

## Key Terms Used In This Chapter

10-222. The following is a list of the key terms used in this Chapter. These terms, and their meanings, are compiled in the Glossary located at the back of the Study Guide.

Annuitant
Annuity
Beneficiary
Canada Pension Plan (CPP)
Deferred Income Plans
Deferred Profit Sharing Plan
Defined Benefit Plan
Defined Contribution Plan
Earned Income (RRSP Limit)
Employment Income
Fixed Term Annuity
Home Buyer's Plan (HBP)
Income Attribution
Income Splitting
Individual Pension Plan
Life Annuity
Lifelong Learning Plan (LLP)
Money Purchase Limit
Money Purchase Plan
Past Service Cost
Past Service Pension Adjustment (PSPA)
Pension Adjustment (PA)
Pension Adjustment Reversal (PAR)
Pension Income Tax Credit
Phased Retirement
Pooled Registered Pension Plan
Profit Sharing Plan
Refundable Part XI.3 Tax
Registered Pension Plan (RPP)
Registered Retirement Income Fund (RRIF)
Registered Retirement Savings Plan (RRSP)
Retirement Compensation Arrangement
Retiring Allowance
Rollover
RRSP Deduction Limit
RRSP Deduction Room
RRSP Dollar Limit
Salary Deferral Arrangement
Spousal RRSP
Spouse
Target Benefit Plans
Tax Deferral
Unused RRSP Deduction Room
Vested Benefit
Vested Contribution

## References

10-223. For more detailed study of the material in this Chapter, we would refer you to the following:

| | |
|---|---|
| ITA 144 | Employees Profit Sharing Plans |
| ITA 146 | Registered Retirement Savings Plans |
| ITA 146.01 | Home Buyers' Plan |
| ITA 146.02 | Lifelong Learning Plan |
| ITA 146.3 | Registered Retirement Income Funds |
| ITA 147 | Deferred Profit Sharing Plans |
| ITA 147.1 | Definitions, Registration And Other Rules (Registered Pension Plans) |
| ITA 147.2 | Pension Contributions Deductible – Employer Contributions |
| ITA 147.3 | Transfer – Money Purchase To Money Purchase, RRSP Or RRIF |
| ITA 147.4 | RPP Annuity Contract |
| ITR 8503 (16) to (25) | Defined Benefit Provisions - Phased Retirement |
| IC 13-1R1 | Pooled Registered Pension Plans (PRPPs) |
| IC 72-13R8 | Employees' Pension Plans |
| IC 72-22R9 | Registered Retirement Savings Plans |
| IC 78-18R6 | Registered Retirement Income Funds |

| | |
|---|---|
| S2-F1-C2 | Retiring Allowances |
| S3-F10-C1 | Qualified Investments - RRSPS, RESPs, RRIFs, RDSPs, and TFSAs |
| S3-F10-C2 | Prohibited Investments - RRSPs, RRIFs, and TFSAs |
| S3-F10-C3 | Advantages - RRSPs, RESPs, RRIFs, RDSPs, And TFSAs |
| IT-124R6 | Contributions To Registered Retirement Savings Plans |
| IT-167R6 | Registered Pension Plans — Employees' Contributions |
| IT-280R | Employees Profit Sharing Plans - Payments Computed By Reference To Profits |
| IT-307R4 | Spousal Or Common-Law Partner Registered Retirement Savings Plans |
| IT-379R | Employees Profit Sharing Plans — Allocations To Beneficiaries |
| IT-500R | Registered Retirement Savings Plans — Death of An Annuitant |
| IT-528 | Transfer Of Funds Between Registered Plans |
| RC4112 | Lifelong Learning Plan (Guide) |
| RC4177 | Death Of An RRSP Annuitant (Pamphlet) |
| T4040 | RRSPs And Other Registered Plans For Retirement (Guide) |
| T4041 | Retirement Compensation Arrangements (Guide) |

# Problems For Self Study (Online)

To provide practice in problem solving, there are Self Study and Supplementary Self Study problems available on MyLab Accounting.

Within the text we have provided an indication of when it would be appropriate to work each Self Study problem. The detailed solutions for Self Study problems can be found in the print and online Study Guide.

We provide the Supplementary Self Study problems for those who would like additional practice in problem solving. The detailed solutions for the Supplementary Self Study problems are available online, not in the Study Guide.

The .PDF file "Self Study Problems for Volume 1" on MyLab contains the following for Chapter 10:

- 9 Self Study problems,
- 5 Supplementary Self Study problems, and
- detailed solutions for the Supplementary Self Study problems.

# Assignment Problems

(The solutions for these problems are only available in the solutions manual that has been provided to your instructor.)

### *Assignment Problem Ten - 1*

***(Calculation Of PAs And PSPAs)***

In each of the following **independent** Cases, calculate the Pension Adjustment (PA) or Past Service Pension Adjustment (PSPA) that would be reported by the employer:

**Case A** John Brokow's employer sponsors both a defined contribution RPP and a DPSP. He is a member of both. During 2019, his employer contributes, on his behalf, \$3,200 to the RPP and \$1,100 to the DPSP. In addition, Mr. Brokow contributes \$1,500 to the RPP. His employment earnings for 2019 are \$120,000. Calculate his 2019 PA.

**Case B** Sarah Halfhill's employer sponsors a defined benefit RPP and, during 2019, contributes \$3,100 on her behalf. Sarah also contributes \$3,100 to the plan in 2019. The plan provides a benefit equal to 1.65 percent of pensionable earnings for each year of service. Sarah's pensionable earnings for 2019 are \$52,000. Calculate her 2019 PA.

**Case C** Bob Carver has worked for his current employer since 2017. In January, 2019, this employer institutes a defined benefit RPP, with benefits extended for all years of service prior to the inception of the plan. The benefit formula calls for a retirement benefit equal to 1.1 percent of pensionable earnings for each year of service. In the current year and both previous years, Bob's pensionable earnings were \$48,000. Calculate his 2019 PSPA and PA.

**Case D** Marianne Underwood has worked for her current employer since 2017. She has been a member of her employer's defined benefit RPP during all of this period. In January, 2019, her employer agrees to retroactively increase the benefit formula from 1.4 percent of pensionable earnings for each year of service, to 1.7 percent of pensionable earnings for each year of service. In the current year and both previous years, Marianne's pensionable earnings were \$52,000. Calculate her 2019 PSPA and PA.

### *Assignment Problem Ten - 2*

#### *(Excess RRSP Contributions)*

As she was attending university during 2015, 2016, and 2017, Karla had no Earned Income for RRSP purposes in any of these three years. However, before returning to university she had been employed and, reflecting this, on January 1, 2017, she has RRSP deduction room of $21,300. She also has undeducted contributions on this date of $15,250.

She returned to work on a part time basis in 2018, resulting in Earned Income for RRSP purposes of $19,100. Also during 2018, she receives a bequest from the estate of her father in the amount of $225,000. She immediately contributes $25,000 of this inheritance to her RRSP. She does not deduct any RRSP contributions during this year. She also makes sufficient charitable donations that her 2018 Tax Payable is reduced to nil.

During 2019, she resumes full time employment, resulting in a 2019 Earned Income for RRSP purposes of $47,800. While she claims her maximum RRSP deduction for 2019, she makes no further contributions to the plan during the year.

**Required:**

A. Determine Karla's maximum RRSP deduction for 2019.

B. Determine the ITA 204.1 penalty (excess RRSP contributions) that would be assessed to Karla for the year ending December 31, 2019.

C. Determine the amount of contributions that Karla would have to withdraw from her RRSP on January 2, 2020 in order to avoid being assessed a penalty under ITA 204.1. What advice would you give to Karla regarding her retirement savings?

### *Assignment Problem Ten - 3*

#### *(Net Income With RRSP Contributions)*

During 2018, Mr. Jeff Singer has the following amounts of income and deductions that will be used in calculating his Net Income For Tax Purposes:

**Net Employment Income** Jeff's net employment income was $59,000. This included commissions of $12,000 and taxable benefits of $6,000. It was after deductions which totaled $8,000. This $8,000 amount included contributions to the employer's RPP of $1,500. The employer made a matching contribution of $1,500 and, in addition, contributed $1,000 to a deferred profit sharing plan on Jeff's behalf.

**Property Income** Jeff's property income was made up of interest of $2,300, eligible dividends received of $1,400, and royalties of $5,000. The royalties were on a software application that he developed in a previous year. He also had a net rental loss of $27,200.

**Capital Gains And Losses** During 2018, Jeff had taxable capital gains of $62,000 and allowable capital losses of $6,000. In the determination of his 2018 Taxable Income, he deducted a net capital loss carry forward of $56,000 [(1/2)($112,000)].

**Other Income And Deductions** During 2018, Jeff received $12,000 in spousal support payments from his first wife. As he has custody of his 14 year old son from this marriage, he also receives $11,000 in child support payments. In addition, Jeff paid $24,000 in spousal support payments to his second wife. As he has decided to remain single for the rest of his life, he has deductible child care costs during 2018 of $5,000.

Jeff has $18,000 in unused deduction room and $20,000 in undeducted contributions at the end of 2018, but Jeff did not make an RRSP deduction in 2018. This is as the result of advice from his brother, who read on an investing blog that this would protect him if his RRSP investments lost value.

**Required:**

A. Calculate Jeff's 2018 Net Income For Tax Purposes.

B. Based on the information provided, calculate:

- the maximum RRSP contribution that Jeff can make for 2019 without incurring a penalty;
- Jeff's maximum RRSP deduction for 2019 and any remaining undeducted contributions, assuming he makes the maximum contribution that you have calculated.

C. Assume that, in addition to the information provided in the problem, Jeff has 2018 net business income of $175,000. Using this new information, provide the information required in Part B.

### Assignment Problem Ten - 4

#### (RRSPs, TFSAs And Tax Planning)

For more than 10 years, Hazel Swilling had been living with and supported by her husband, Giorgio. As he had become increasingly abusive when he was drinking (which was often), she moved out in May, 2018 and commenced divorce proceedings. She had married shortly after graduating from college at the age of 22 and had no earned income prior to 2018.

After an extensive search for employment, in November, 2018, she found a position with an annual salary of $36,000 per year. Her gross employment income for the November and December months of 2018 was $6,000.

Hazel's new employer sponsors a defined benefit pension plan. For 2018, $400 was withheld from Hazel's wages as a contribution to this plan. In addition, the employer made a matching contribution of $400.

Once Giorgio realized that Hazel had left him for good, he joined Alcoholics Anonymous. He eventually accepted they had irreconcilable differences and decided to work out equitable terms for an amiable split. In July, they decided that Giorgio would retain their principal residence and that on August 31, he would give Hazel a rental property that he had purchased after they had married. He had paid $423,000 for this property, with $100,000 of this total being the estimated fair market value of the land. Information on this property is as follows:

| | |
|---|---|
| August 31, 2018 Fair Market Values | |
| Land | $120,000 |
| Building | 375,000 |
| January 1, 2018 UCC Of Building | 280,054 |
| Net Rental Loss (Before CCA) | |
| For September 1 to December 31, 2018 | 2,600 |

The September 1, 2018 divorce settlement required him to make a lump-sum payment of $98,000, plus $2,500 per month in spousal support. The $98,000 was deposited in a savings account and, during the September 1 through December 31, 2018 period, interest of $653 was accrued in this account. The required $2,500 per month payments were made for September through December, 2018.

Other sources of funds for Hazel during 2018 are as follows:

- An inheritance from her mother's estate of $62,000.
- Eligible dividends from Canadian public companies of $1,800.

For both 2018 and 2019, Hazel does not anticipate that her income will exceed the limit for the lowest federal tax bracket of 15 percent. However, she anticipates that for the 2020 taxation year, her income will place her in the 26 percent tax bracket.

**Required:**

A. Calculate Hazel's net employment income for 2018.

B. Determine Hazel's maximum deductible RRSP contribution for 2019.

C. As Hazel's personal financial consultant, what advice would you give her regarding her TFSA and RRSP contribution and deduction for 2019?

## *Assignment Problem Ten - 5*

### *(Employment Income With RRSP)*

Ms. Stratton has been the controller for a large publicly traded corporation for the last five years. The following information relates to the year ending December 31, 2019:

1. Ms. Stratton had a gross salary of $130,000, from which her employer made the following deductions:

| | |
|---|---|
| Income taxes | $33,342 |
| Registered Pension Plan contributions | 2,390 |
| Employment Insurance premiums | 860 |
| Canada Pension Plan contributions | 2,749 |
| Contributions to registered charities | 1,600 |
| Employee's portion of benefit plans (See Point 2 below) | 1,436 |

2. It is the policy of the company to pay one-half of the cost of certain benefit plans. The following amounts were paid by the company for Ms. Stratton:

| | |
|---|---|
| Group term life insurance | $ 96 |
| Provincial health insurance plan | 482 |
| Dental plan | 173 |
| Major medical care (Private insurer) | 396 |
| Group income protection | 289 |
| Total | $1,436 |

3. Ms. Stratton's employer paid $2,300 for her annual membership in the Hot Rocks Curling Club. Ms. Stratton uses the club largely for employment related entertaining.

4. Ms. Stratton was awarded a one week trip to Bermuda by her employer for being with the company for fifteen long years. The fair market value of this trip was $5,000.

5. Ms. Stratton is required to travel to the offices of her employer's clients on a regular and continuing basis. As a result, her employer reimburses her for actual expenses. These payments totaled $8,462 for the year.

6. During the year, Ms. Stratton paid professional dues of $225.

7. During the year, Ms. Stratton made contributions to a Registered Retirement Savings Plan (RRSP) in the amount of $20,000 and to a Tax Free Savings Account (TFSA) in the amount of $6,000 (her maximum contribution room). At the end of 2018, Ms. Stratton's Unused RRSP Deduction Room was nil and she had no undeducted RRSP contributions. Her employer reported that she had a 2018 Pension Adjustment of $5,560. Her Earned Income for 2018 is equal to her 2019 Earned Income.

**Required**:

A. Calculate Ms. Stratton's net employment income for the year ending December 31, 2019 and indicate the reasons that you have not included items in your calculations. Ignore GST/HST/PST implications.

B. Calculate Ms. Stratton's maximum RRSP deduction for 2019.

C. Comment on the advisability of her $20,000 contribution to her RRSP.

### Assignment Problem Ten - 6

#### (Net Income And RRSP Contributions)

During the year ending December 31, 2019, Valerie Arnold operated an unincorporated business. Using GAAP procedures, the business had a Net Income of $140,823. Information related to this business is as follows:

- As a result of meetings with various clients and suppliers, Valerie incurred meal and entertainment costs of $7,250. This amount was deducted in determining accounting income.
- Amortization in the amount of $21,350 was deducted in the determination of accounting net income. Maximum CCA, which Valerie intends to deduct, was determined to be $29,730.
- During 2019, the business sold depreciable assets that had a capital cost of $65,000. On January 1, 2019 the net book value of these assets was $51,000 and the UCC balance of their CCA Class was $43,248. They were sold for a total of $35,000. These assets were the only assets in their Class and no additions were made to the Class during 2019.

**Other Information**

Other information required to complete Valerie's tax return is as follows:

1. At the beginning of 2019, Valerie had Unused RRSP Deduction Room of $8,400. She had made contributions of $9,300 on February 27, 2019 that she forgot to deduct on her 2018 return. She would like to deduct the contributions on her 2019 tax return.
2. She had the following amounts of investment income and capital gains during 2019:

| | |
|---|---|
| Interest On Her Savings Account | $ 960 |
| Capital Gains From The Sale Of Personal Assets | 29,400 |
| Capital Losses From The Sales Of Shares | ( 7,600) |
| Eligible Dividends Received | 5,650 |

3. She received royalties on a Study Guide that she prepared for the college market. The total amount for 2019 was $9,340.
4. She paid spousal support during 2019 of $18,000.

**Required:**

A. For the 2019 taxation year, calculate Valerie's minimum Net Income For Tax Purposes before any deduction is made for RRSP purposes. Ignore CPP contributions in your calculations.

B. Calculate the maximum RRSP deduction that can be made by Valerie for 2019. In making this calculation, assume that Valerie's 2018 Earned Income is equal to her 2019 Earned Income. Determine the amount of additional contributions that she would have to make in order to make the maximum RRSP deduction.

### Assignment Problem Ten - 7

#### (Net Income And RRSP Contributions)

Alicia Arnold operates an unincorporated business with a December 31 year end. During the year ending December 31, 2019, accounting Net Income for this business was $183,000. Other information related to the 2019 operations of this business are as follows:

1. Amortization deducted in the determination of accounting Net Income was $23,000. Her tax advisor has calculated maximum CCA for this period of $31,000.
2. During the year, the business sold depreciable assets for $34,500. The net book value of the assets was $24,000, their capital cost was $30,000, and their UCC on January 1, 2019 was $18,000.

3. During the year, Alicia spent $14,000 on business meals and entertainment. This amount was deducted in the determination of accounting Net Income.

Other information related to Alicia's tax position is as follows:

| | |
|---|---|
| Interest On Savings Account | $ 1,200 |
| Taxable Capital Gains On Personal Assets | 18,000 |
| Allowable Capital Loss On Sale Of Shares | 1,000 |
| Spousal Support Paid | 3,600 |
| Royalties On Cookbook That She Authored | 8,400 |

At the beginning of 2019, Alicia had Unused RRSP Deduction Room of $6,500. She also had undeducted contributions of $4,500.

**Required:**

A. For the 2019 taxation year, calculate Alicia's minimum Net Income For Tax Purposes before any deduction is made for RRSP purposes. Ignore CPP contributions in your calculations.

B. Calculate the maximum RRSP deduction that can be made by Alicia for 2019. In making this calculation, assume that Alicia's 2018 Earned Income is equal to her 2019 Earned Income. Determine the amount of additional contributions that she would have to make in order to make the maximum RRSP deduction.

## Assignment Problem Ten - 8
### (Comprehensive Case Covering Chapters 1 to 10)

### Family Information
Roland Sorter has been married to Rachel since their graduation from university. They have two healthy children:

**Richard** Their son, Richard is 14 years old. He has 2019 income from part time jobs of $2,300.

**Roxanne** Their daughter, Roxanne is 11 years old. Her 2019 income, also from part time jobs, is $3,600.

The family's medical expenses, all paid for by Rachel are as follows:

| | |
|---|---|
| Prescription Glasses For Roland | $ 625 |
| Rhinoplasty For Rachel (See Rachel's Business Income) | 9,350 |
| Physiotherapy Fees For Richard And Roxanne | 1,475 |
| Dental Braces For Richard | 8,560 |
| Psychologist Consulting Fees For Roxanne | 2,450 |
| Total | $22,460 |

During 2019, Roland worked 225 hours as a voluntary firefighter. He did not receive any compensation for his work.

### Rachel's Business Income
Rachel is a lawyer who has an unincorporated professional practice specializing in lucrative contracts for TV and movie actresses. Her practice has a December 31 year end.

From childhood, Rachel has been embarrassed by the size and shape of her nose. Since her clients put a lot of emphasis on looking beautiful, Rachel felt that her nose stood in the way of getting more important clients and had rhinoplasty surgery in 2018. It was not required for medical reasons. Unfortunately, complications from Rachel's surgery in 2018 resulted in a significant decrease in her revenues for that year. She was also very disappointed with the results of the rhinoplasty surgery.

In 2019, she was introduced to a doctor who said he could greatly improve the look of her nose. She was convinced and the operation was a success.

During 2019, the revenues from her legal practice totalled $411,000, double what she anticipated. Rachel credited her perfected nose for much of the increase in business.

She operates her practice out of a building that she purchased for this purpose in 2015. The building was acquired for $675,000 of which $175,000 reflected the estimated fair market value of the land. When purchased, the building was new and it has been allocated to a separate Class 1 for CCA purposes. Rachel's practice uses all of the building. On January 1, 2019, the building has a UCC value of $433,521.

During the year 2019, Rachel renovated her offices, replacing the old furniture and fixtures with new furniture and fixtures at a cost of $67,000. The older furniture and fixtures were sold for $13,000. These older assets had a capital cost of $29,500 and a January 1, 2019 UCC of $13,594.

During 2019, Rachel acquired other assets as follows:

- A client list from a retiring lawyer for $23,000.
- A new laptop computer for $1,400.
- Applications software for $3,600.

As she offers mobile legal services as part of her practice, Rachel uses an automobile in her business. She retired her previous vehicle at the end of 2018 and, on January 1, 2019, she acquired a new BMW for $53,000. During 2019, it was driven 21,000 kilometers, 3,000 of which involved personal use. Operating costs for the vehicle during 2019 totaled $4,200.

Other 2019 costs of operating her business, determined on an accrual basis, are as follows:

| | |
|---|---|
| Building Operating Costs | $29,400 |
| Salaries And Wages | 53,200 |
| Office Costs | 21,800 |
| Meals With Clients | 8,600 |

### *Roland's Employment Income*

Roland works for a large Canadian public company. His 2019 salary is $66,500, none of which involves commissions. His employer withholds the following amounts during the year:

| | |
|---|---|
| Registered Pension Plan Contributions* | $2,300 |
| EI Premiums | 860 |
| CPP Contributions | 2,749 |
| Union Dues | 460 |

*Roland's employer makes a matching contribution of $2,300.

Roland's work requires some amount of travel. He uses his own vehicle for this travel. This vehicle was acquired on January 1, 2019 at a cost of $29,500. During 2019, he drove the vehicle 28,000 kilometers, of which 22,600 were employment related. His total operating costs for the year were $5,600.

In addition to automobile costs, Roland has other travel costs as follows:

| | |
|---|---|
| Hotels | $2,800 |
| Food On Out Of Town Trips | 930 |

In addition to his salary, Roland's employer provides him with the following allowances for travel:

| | |
|---|---|
| Hotels And Out Of Town Meals | $3,800 |
| Use Of Personal Automobile ($700 Per Month) | 8,400 |

***Investment Information***

All of the family's investments are in Rachel's name and purchased with her own funds. During 2019, these investments produced the following amounts of income:

| | |
|---|---:|
| Capital Gains On The Sale Of Public Company Shares | $12,750 |
| Eligible Dividends | 11,500 |
| Interest Income | 6,300 |
| Total | $30,550 |

Roland has no 2019 investment income.

***RRSP Information***

Roland and Rachel have both invested on a regular basis in RRSPs. Information related to these plans is as follows:

**Rachel's Plan** At the beginning of 2019 there was $6,500 of unused deduction room in Rachel's plan. Due to her decreased income in 2018, she did not deduct all of her RRSP contributions. As of January 1, 2019 there was $8,800 in undeducted contributions. During 2019, Rachel contributes an additional $14,500 to her plan.

Rachel's 2018 Earned Income for RRSP purposes was $116,000. She did not have a pension adjustment.

She would like to take the maximum deduction that is available on the basis of this information.

Three years earlier, during 2016, Rachel removed $18,000 from her RRSP under the provisions of the Home Buyers' Plan. After selling the family's existing residence in early 2017, Rachel used these funds, along with the proceeds from the old home, to acquire a new residence. Due to a continued oversight on the part of her myopic accountant, she did not designate any of her RRSP contributions as repayments of the Home Buyers' Plan funds in either 2018 or 2019.

**Roland's Plan** At the beginning of 2019, Roland had unused deduction room in his plan of $5,500. He had no undeducted contributions. During 2019, Roland contributes $4,500 to his plan. He plans to take the maximum deduction available for 2019.

At the beginning of 2019, after lengthy negotiations with his union, Roland's employer agrees to increase the benefit formula in the Company's defined benefit plan. The annual benefit will be increased from 1.75 of pensionable earnings to 2.00 percent of pensionable earnings. This change will be applied retroactively to the years 2017 and 2018. Roland has been a member of the plan for over 10 years. His pensionable earnings during the retroactive years were as follows:

| Year | Pensionable Earnings |
|---|---:|
| 2017 | $37,000 |
| 2018 | 42,000 |

Roland's 2018 Earned Income for RRSP purposes was $48,000. His employer reported a pension adjustment for that year of $4,100.

Roland and Rachel will allocate tax credits between them to minimize the family's tax liability. Where either spouse can claim the credit and it makes no difference in the combined tax payable, Rachel will claim the credit.

**Required:** Ignore GST/HST/PST considerations in your solution.

A. Determine Rachel's Net Income For Tax Purposes and Taxable Income for 2019.

B. Determine Rachel's federal Tax Payable and her CPP liability for 2019.

C. Determine Roland's Net Income For Tax Purposes and Taxable Income for 2019.

D. Determine Roland's federal Tax Payable for 2019.

### Assignment Problem Ten - 9

***(Comprehensive Case Covering Chapters 1 to 10 - Three Individuals)***

Zhi and Meng Liu are both 45 years old. They are married and support Zhi's 19 year old son from his former marriage, Sheng. In January, 2019, the family moved from Edmonton, Alberta to London, Ontario, so that Zhi could accept a new position. Meng continued her party planning business in London. What follows is information about the income of each of the three family members.

**1. Information About Zhi's Income**

a. In 2019, Zhi earned $170,000 from employment, all of it after the move from Edmonton to London. CPP of $2,859 and EI of $860 were deducted from Zhi's employment income during 2019.

b. The following expenses were incurred as a result of the move from Edmonton to London:

| | |
|---|---|
| Air Fare - House Hunting Trip To London | $ 550 |
| Hotel And Meals (3 Days) - London Trip | 500 |
| Airfare For Moving Family (1 Day Of Travel) | 2,000 |
| Costs - Waiting For New Home (20 Days) | |
| Hotel (All Receipts Available) | 3,000 |
| Meals (No Receipts Available) | unknown |
| Cost Of Repairing Old Home For Sale | 1,000 |
| Legal Fees And Commission - Old Home | 3,700 |
| Actual Loss On Sale Of Old Home | 27,000 |
| Transportation Of Household Goods | 4,900 |
| Legal Fees - New Home | 2,900 |
| Decorations For New Home | 9,500 |

c. Zhi received a moving allowance of $8,000 from his new employer.

d. Zhi and his former spouse divorced in 2009. As per their divorce settlement, Zhi's former spouse has paid him an annual amount of $6,000 in spousal support payments since then.

e. Zhi and Meng share a joint personal chequing and savings account. The interest earned on the account for 2019 was $350. Both Zhi and Meng contribute equally to this account.

f. Zhi had invested in Matel Industries Inc. (a public company) over the years, and on January 30, 2019 he sold 250 shares for $20 each. His history of trading in these shares was as follows:

May 24, 2011 - Purchased 130 shares @ $26 per share
June 30, 2012 - Purchased 170 shares @ $31 per share
October 31, 2014 - Purchased 300 shares @ $29 per share
June 9, 2015 - Sold 400 shares @ $15 per share
July 5, 2015 - Purchased 400 shares @ $12 per share
June 3, 2018 - Purchased 385 shares @ $18 per share

g. Zhi borrowed $10,000 to make an RRSP contribution in 2018. Interest on this loan paid in 2019 was $500. The RRSP contribution was properly deducted in 2018. Zhi had a Notice of Assessment from 2018 that indicated his 2019 deduction limit was $4,000, and also indicated that there were no undeducted contributions. In 2014, Zhi withdrew RRSP funds under the Home Buyers' Plan. His Notice of Assessment indicated that a repayment of $1,500 was required under the Home Buyers' Plan for 2019. Zhi did not make the necessary contribution in 2019 or the first 60 days of 2020. A repayment of the same amount will be required on the Home Buyers' Plan in 2020 or the first 60 days of 2021.

h. Zhi inherited a rental property from his mother, Mrs. Liu, who passed away in 2019. The relevant details are provided in Appendix A.

**2. Information About Meng's Income**

a. Meng's income is business income from her business, Meng's Party Services. Financial information related to this business is provided in Appendix B.

b. Meng made an RRSP contribution on October 31, 2019 in the amount of $12,000. According to her 2018 Notice of Assessment, her deduction limit for 2019 was $8,000. She had no undeducted contributions after filing her 2018 tax return.

c. See Zhi's information for interest on the joint chequing account.

**3. Information About Sheng**

a. Sheng is a full time university student. He paid $6,000 in tuition in 2019. Of this total, $3,000 was for the 4 months he attended in 2019, and the balance was for 2020. He was enrolled in University full time for 4 months in 2019. Sheng is willing to transfer any unused part of his tuition tax credit to his mother.

b. Zhi's wealthy ailing father, a Canadian resident and Sheng's grandfather, has given Sheng $100,000 to make him more marriageable in the hopes he will marry soon and have a son to carry on the lineage. The grandfather has promised more funds at the wedding if he is still alive. Sheng was uncertain as to how to deal with this situation, so on February 15, 2019, he invested the $100,000 in an interest bearing term deposit at 4 percent. Interest is paid every 6 months.

c. Sheng was the successful applicant for a scholarship and was awarded $1,000 to assist him with his tuition costs.

d. Sheng's payments from his RESP in 2019 consisted of the following:

| | |
|---|---:|
| Accumulated Earnings | $1,000 |
| Canada Education Savings Grant Payment | 2,500 |
| Payment Of Contributions By Zhi And Meng | 7,500 |

e. Sheng had employment income of $10,000 which he earned working as a server for his mother's business. He has worked in the business since he was 10 years old. As Sheng is related to his employer, these earnings are not insurable and no EI was deducted from his pay. CPP premiums of $332 were correctly calculated and deducted by his employer.

**Required:** In determining the following amounts, ignore GST, PST and HST considerations.

A. For the 2019 taxation year, calculate Zhi Liu's minimum:

1. Net Income For Tax Purposes,
2. Taxable Income,
3. Federal Balance Owing Or Refund (Tax Plus Any CPP Contributions).

B. For the 2019 taxation year, calculate Sheng Liu's minimum:

1. Net Income For Tax Purposes,
2. Taxable Income,
3. Federal Tax Payable.

C. For the 2019 taxation year, calculate Meng Liu's minimum:

1. Net Income For Tax Purposes,
2. Taxable Income,
3. Federal Balance Owing Or Refund (Tax Plus Any CPP Contributions).

D. Determine the amounts of any carry forwards available to Zhi or Meng. In addition, indicate the ending UCC balances for Meng's business assets.

E. Determine the maximum deductible RRSP contribution for Zhi and Meng for 2020. What advice would you give them regarding their RRSP contributions and other tax planning considerations?

### Appendix A - Inherited Rental Property

On October 10, 2019, Zhi's mother, Ms. Liu, passed away. At her death, Ms. Liu owned a small apartment building with a cost of $350,000. Of the total cost, $100,000 was allocated to the land with the $250,000 balance going to the building. For CCA purposes, the building was included in Class 1. At the beginning of 2019, the UCC of the building was $170,000.

At the time of her death, the fair market value of the land was $212,000 and the fair market value of the building was $325,000. The property was transferred to Zhi on October 11, 2019. Rental income received by Zhi for his period of ownership from October 11 until December 31, 2019 was $26,000. Rental expenses before CCA totalled $22,000.

### Appendix B - Meng's Business Income

The business provides complete party planning services for all occasions. A summarized Income Statement is as follows:

**Meng's Party Services**
**Statement Of Income**
**For the year ended December 31, 2019**

| | | |
|---|---|---|
| Sales | | $561,000 |
| Expenses: | | |
| General And Administrative | ($485,120) | |
| Amortization Of Fixed Assets | ( 28,170) | ( 513,290) |
| Operating Profit | | $ 47,710 |
| Gain On Disposal Of Fixed Assets (See Details Below) | | 99,290 |
| Net Income | | $147,000 |

General and administrative expenses includes a payment of $50,000 in drawings to Meng.

The UCC balances of the business assets as at January 1, 2019 were:

| | |
|---|---|
| Class 1 | $30,000 |
| Class 6 (Fence) | 2,100 |
| Class 8 | 2,000 |
| Class 10 | 11,000 |

In January, 2019, as a result of the move to London, Meng sold the owned business premises and some other business assets. The Class 6 asset listed is the fence that was erected around the former business premises. On the sale of these premises, no proceeds were allocated to the fence. This was the only asset in Class 6.

The details of the asset sales at the time of the move are as follows:

| | Proceeds | Original Cost | Net book value |
|---|---|---|---|
| Land | $ 20,000 | $ 5,000 | $ 5,000 |
| Class 1 building | 125,000 | 45,000 | 40,000 |
| Class 8 chairs and tables | 6,000 | 8,000 | 5,120 |
| Delivery van | 4,500 | 18,000 | 6,175 |
| Office equipment | 5,000 | 15,000 | 4,915 |
| Class 6 fence | Nil | 3,000 | Nil |

To facilitate the sale, Meng agreed to take 10 percent of the total purchase price as a down payment, with the balance due in 2020.

Meng found leased premises in London that meet her needs, however, she was not happy with the external appearance of the leased premises. She had landscaping work completed around the new leased office space at a cost of $12,000. For 2019, no amortization of this work was deducted in the determination of accounting Net Income.

During the year, the business purchased the following new depreciable assets:

| | |
|---|---|
| Office Furniture | $15,000 |
| Delivery Van | 30,000 |
| Computer Equipment And Systems Software | 10,000 |
| Photocopier (No Separate Class Election Was Filed) | 2,600 |

# INDEX

## A



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## W



## Z

# NOTES

# NOTES

# NOTES

# NOTES

# PREFACE

## Complete Preface In Volume I

The complete preface to this three volume set of ***Byrd & Chen's Canadian Tax Principles*** can be found in Volume I.

## Online Student Supplements

### MyLab Accounting

MyLab Accounting for *Canadian Tax Principles* contains a great deal of additional material that will provide significant assistance to users of this text. Instructions on how to access MyLab can be found on the access card provided with this package. The URL for MyLab is:

**http://www.pearsonmylabandmastering.com**

The various items that are included on MyLab can be described as follows:

- Corrections to the textbook and Study Guide. Please check periodically to help avoid frustration.
- Pearson eText of the complete set - 2 Volumes plus Study Guide
- Self Study Problems (The solutions are in the print and online Study Guide)
- Supplementary Self Study Problems and Solutions
- Access to CPA Canada's Federal Income Tax Collection (FITAC)
- Access to Intuit Canada's ProFile tax return preparation software
- Practice Examinations and Solutions
- Power Point Presentations
- Glossary Flashcards
- 2019 tax rates, credits and common CCA Classes (PDF file)
- Tax Returns for examples and Self Study tax return problems

# 2019 Rates, Credits And Other Data

For your convenience, this information, as well as the Chapter 5 Appendix of common CCA rates, is available **online** as a .PDF file.

## Information Applicable To Individuals

### *Federal Tax Rates For Individuals*

| Taxable Income In Excess Of | Federal Tax | Marginal Rate On Excess |
|---|---|---|
| $ -0- | $ -0- | 15.0% |
| 47,630 | 7,145 | 20.5% |
| 95,259 | 16,908 | 26.0% |
| 147,667 | 30,535 | 29.0% |
| 210,371 | 48,719 | 33.0% |

### *Federal Tax Credits For Individuals - Personal Credits (ITA 118)*

**Reference**

**118(1)(a)** **Married Persons** 15% of $12,069 ($1,810).

**118(1)(a)** **Spousal** 15% of $12,069 ($1,810), less 15% of the spouse's Net Income For Tax Purposes. Base amount increased by $2,230 (to $14,299) if the spouse is mentally or physically infirm. Not available when the spouse's income is more than $12,069 (or $14,299).

**118(1)(b)** **Eligible Dependant** 15% of $12,069 ($1,810), less 15% of the eligible dependant's Net Income For Tax Purposes. Base amount increased by $2,230 (to $14,299) if the eligible dependant is mentally or physically infirm. Not available when the eligible dependant's income is more than $12,069 (or $14,299).

**118(1)(b.1)** **Canada Caregiver For Child Under 18** 15% of $2,230 ($335).

**118(1)(c)** **Single Persons** 15% of $12,069 ($1,810).

**118(1)(d)** **Canada Caregiver** 15% of $7,140 ($1,071), reduced by 15% of the dependant's income in excess of $16,766.

**118(1)(e)** **Canada Caregiver - Additional Amount** If either the income adjusted infirm spousal credit base or the income adjusted infirm eligible dependant credit base is less than the spouse or eligible dependant's income adjusted credit base ($7,140, less the spouse or dependant's income in excess of $16,766), an additional Canada caregiver credit is available based on 15% of the deficiency.

**118(2)** **Age** 15% of $7,494 ($1,124). The base for this credit is reduced by the lesser of $7,494 and 15% of the individual's net income in excess of $37,790. Not available when income is more than $87,750. If the individual cannot use this credit, it can be transferred to a spouse or common-law partner.

**118(3)** **Pension** 15% of up to $2,000 of eligible pension income for a maximum credit of $300 [(15%)($2,000)]. If the individual cannot use this credit, it can be transferred to a spouse or common-law partner.

**118(10)** **Canada Employment Credit** 15% of up to $1,222. This produces a maximum credit of $183.

## *Other Common Federal Personal Credits (Various ITA)*

118.01 **Adoption Expenses Credit** 15% of eligible expenses (reduced by any reimbursements) up to a maximum of $16,255 per adoption. This results in a maximum credit of $2,438.

118.041 **Home Accessibility Credit** 15% of lesser of $10,000 and the amount of qualifying expenditures for the year.

118.05 **First Time Home Buyer's Credit** 15% of $5,000 ($750) of the cost of an eligible home.

118.06 **Volunteer Firefighters Credit** 15% of $3,000 ($450) for qualifying volunteers.

118.07 **Volunteer Search And Rescue Workers Credit** 15% of $3,000 ($450) for qualifying volunteers.

118.1 **Charitable Donations - Regular** The general limit on amounts for this credit is 75% of Net Income. There is an addition to this general limit equal to 25% of any taxable capital gains and 25% of any recapture of CCA resulting from a gift of capital property. In addition, the income inclusion on capital gains arising from a gift of some publicly traded shares is reduced from one-half to nil. For individuals, the credit is equal to:

$$[(15\%)(A)] + [(33\%)(B)] + [(29\%)(C)] \text{ where:}$$

A = The first $200 of eligible gifts.
B = The lesser of:
- Total gifts, less $200; and
- Taxable Income, less $210,371.

C = The excess, if any, by which the individual's total gifts exceed the sum of $200 plus the amount determined in B.

118.2 **Medical Expenses** The medical expense tax credit is determined by the following formula:

$$[15\%]\ [(B - C) + D], \text{ where:}$$

**B** is the total of an individual's medical expenses for himself, his spouse or common-law partner, and any of his children who have not reached 18 years of age at the end of the year.
**C** is the lesser of 3% of the individual's Net Income For Tax Purposes and $2,352 (2019 figure).
**D** is the total of all amounts each of which is, in respect of a dependant of the individual (other than a child of the individual who has not attained the age of 18 years before the end of the taxation year), an amount determined by the formula:

$$E - F, \text{ where:}$$

**E** is the total of the dependant's medical expenses
**F** is the lesser of 3% of the dependant's Net Income For Tax Purposes and $2,352 (2019 figure).

118.3 **Disability - All Ages** 15% of $8,416 ($1,262). If not used by the disabled individual, it can be transferred to a person claiming that individual as a dependant.

118.3 **Disability Supplement - Under 18 And Qualifies For The Disability Tax Credit** 15% of $4,909 ($736), reduced by the total of amounts paid for attendant care or supervision in excess of $2,875 that are deducted as child care costs, deducted as a disability support amount, or claimed as a medical expense in calculating the medical expense tax credit.

## Education Related Credits

118.5 • **Tuition Fees Which Includes Examination And Ancillary Fees**
- 15% of qualifying tuition fees
- 15% of examination fees for both post-secondary examinations and examinations required in a professional program
- 15% of ancillary fees that are imposed by a post-secondary educational institution on all of their full or part-time students. Up to $250 in such ancillary fees can be claimed even if not required of all students.

118.62 • **Interest On Student Loans**
15% of interest paid on qualifying student loans.

118.9 • **Transfer Of Tuition Credit**
If the individual cannot use the credit, is not claimed as a dependant by his spouse, and does not transfer the unused credit to a spouse or common-law partner, then a parent or grandparent of the individual can claim up to $750 [(15%)($5,000)] of any unused tuition credit. The amount that can be transferred is reduced by the amount of the credit claimed by the student for the year.

118.7 **Employment Insurance** 15% of amounts paid by employees up to the maximum Employment Insurance premium of $860 (1.62% of $53,100). This produces a maximum tax credit of $129 [(15%)($860)].

118.7 **Canada Pension Plan** 15% of amounts paid by employees up to the maximum Canada Pension Plan contribution of $2,749 [5.1% of ($57,400 less $3,500)]. This produces a maximum tax credit of $412 [(15%)($2,749)]. For self-employed individuals, the payment is $5,498 ($2,749 times 2).

122.51 **Refundable Medical Expense Supplement** The individual claiming this amount must be over 17 and have earned income of at least $3,645. The amount is equal to the lesser of $1,248 and 25/15 of the medical expense tax credit. The refundable amount is then reduced by 5% of family Net Income in excess of $27,639. Not available when family income is more than $52,599.

122.9 **Refundable Teacher And Early Childhood Educator School Supply Tax Credit** A maximum of 15% of up to $1,000 ($150) of eligible expenditures that are made by eligible educators.

127(3) **Political Donations** Three-quarters of the first $400, one-half of the next $350, one-third of the next $525, to a maximum credit of $650 on donations of $1,275.

127.4 **Labour Sponsored Venture Capital Corporations (LSVCC) Credit** The federal credit is equal to 15 percent of acquisitions of provincially registered LSVCCs.

ITA 82 and ITA 121 **Dividend Tax Credit**

- **Eligible Dividends** These dividends are grossed up by 38%. The federal dividend tax credit is equal to 6/11 of the gross up. The credit can also be calculated as 15.02% of the grossed up dividends, or 20.7272% of the actual dividends received.
- **Non-Eligible Dividends** These dividends are grossed up by 15%. The federal dividend tax credit is equal to 9/13 of the gross up. The credit can also be calculated as 9.0301% of the grossed up dividends, or 10.3846% of the actual dividends received.

## Other Data For Individuals

ITA 82 **Dividend Gross Up**

**Eligible Dividends** For these dividends, the gross up is 38% of dividends received.

**Non-Eligible Dividends** For these dividends, the gross up is 15% of dividends received.

Chapter 4 **OAS Clawback Limits** The tax (clawback) on Old Age Security (OAS) benefits is based on the lesser of 100% of OAS benefits received, and 15% of the amount by which "threshold income" (Net Income For Tax Purposes, calculated without the OAS clawback) exceeds $77,580.

Chapter 4 **EI Clawback Limits** The tax (clawback) on Employment Insurance (EI) benefits under the *Employment Insurance Act* is based on the lesser of 30% of the EI benefits received, and 30% of the amount by which "threshold income" exceeds $66,375 (1.25 times the maximum insurable earnings of $53,100). For this purpose, "threshold income" is Net Income For Tax Purposes, calculated without the OAS or EI clawbacks.

Chapter 9 **Child Care Expenses** The least of three amounts:

1. The amount actually paid for child care services. If the child is at a camp or boarding school, this amount is limited to a weekly amount $275 (any age if eligible for disability tax credit), $200 (under 7 year of age), or $125 (age 7 through 16 or over 16 with a mental or physical impairment).
2. The sum of the **Annual Child Care Expense Amounts** for the taxpayer's eligible children. The per child amounts are $11,000 (any age if eligible for disability tax credit), $8,000 (under 7 year of age), or $5,000 (age 7 through 16 or over 16 with a mental or physical impairment).
3. 2/3 of the taxpayer's **Earned Income** (for child care expenses purposes).

Chapter 10 **RRSP Deduction Room** For 2019, the addition to RRSP deduction room is equal to:

- the lesser of $26,500 and 18% of 2018 Earned Income,
- reduced by the 2018 Pension Adjustment and any 2018 Past Service Pension Adjustment,
- and increased by any 2018 Pension Adjustment Reversal.

Chapter 11 **Lifetime Capital Gains Deduction** For 2019, the deduction limit for dispositions of shares of qualified small business corporations is $866,912. There is an additional amount for farm or fishing properties of $133,088, providing a total of $1,000,000 for such properties.

**Provincial Tax Rates And Provincial Credits For Individuals** Provincial taxes are based on Taxable Income, with most provinces adopting multiple rates. The number of brackets range from three to five. Provincial tax credits are generally based on the minimum provincial rate applied to a credit base that is similar to that used for federal credits. In addition to regular rates, two provinces use surtaxes.

## Information Applicable To Individuals And Corporations

ITR 4301 **Prescribed Rate** The following figures show the base rate that would be used in calculations such as imputed interest on loans. It also shows the rates applicable on amounts owing to and from the CRA. For recent quarters, the interest rates were as follows:

| Year | Quarter | Base Rate | Owing From* | Owing To |
|---|---|---|---|---|
| 2017 | All | 1% | 3% | 5% |
| 2018 | I | 1% | 3% | 5% |
| 2018 | II to IV | 2% | 4% | 6% |
| **2019** | **I, II** | **2%** | **4%** | **6%** |

*The rate on refunds to corporations is limited to the base rate, without the additional 2%.

**Automobile Deduction Limits**

- CCA is limited to the first $30,000 of the automobiles cost, plus applicable GST/HST/PST (not including amounts that will be refunded through input tax credits).
- Interest on financing of automobiles is limited to $10 per day.
- Deductible leasing costs are limited to $800 per month (other constraints apply).
- Operating cost benefit = $0.28 per kilometre.
- Deductible rates = $0.58 for first 5,000 kilometres, $0.52 for additional kilometres.

**CCA Rates** See Appendix to Chapter 5.

**Quick Method Rates (GST Only)**

| | Percentage On GST Included Sales | |
|---|---|---|
| | First $30,000 | On Excess |
| Retailers And Wholesalers | 0.8% | 1.8% |
| Service Providers And Manufacturers | 2.6% | 3.6% |

**Note** Different rates apply in the provinces that have adopted an HST system.

## Information Applicable To Corporations

**Federal Corporate Tax Rates** are as follows (federal tax abatement removed):

| | |
|---|---|
| General Business (Before General Rate Reduction) | 28% |
| General Business (After General Rate Reduction Of 13%) | 15% |
| Income Eligible For M&P Deduction | 15% |
| Income Eligible For Small Business Deduction | 9% |
| Part IV Refundable Tax | 38-1/3% |
| Part I Refundable Tax On Investment Income Of CCPC (ART) | 10-2/3% |

Reference

89(1) **General Rate Income Pool** A CCPC's General Rate Income Pool (GRIP) is defined as follows:

- The GRIP balance at the end of the preceding year; plus
- 72% of the CCPC's Taxable Income after it has been reduced by amounts eligible for the small business deduction and aggregate investment income; plus
- 100% of eligible dividends received during the year; plus
- adjustments related to amalgamations and wind-ups; less
- eligible dividends paid during the preceding year.

125(1) **Small Business Deduction** is equal to 19% of the least of:

A. Net Canadian active business income.

B. Taxable Income, less:

1. 100/28 times the ITA 126(1) credit for taxes paid on foreign non-business income, calculated without consideration of the additional refundable tax under ITA 123.3 or the general rate reduction under ITA 123.4; and
2. 4 times the ITA 126(2) credit for taxes paid on foreign business income, calculated without consideration of the general rate reduction under ITA 123.4.

C. The annual business limit of $500,000, less any portion allocated to associated corporations, less the grinds for large corporations and passive income.

123.3 **Additional Refundable Tax On Investment Income (ART)** is equal to 10-2/3% of the lesser of:

- the corporation's "aggregate investment income" for the year [as defined in ITA 129(4)]; and
- the amount, if any, by which the corporation's Taxable Income for the year exceeds the amount that is eligible for the small business deduction.

123.4(2) **General Rate Reduction** is equal to 13% of Full Rate Taxable Income. This is Taxable Income, reduced by; income eligible for the small business deduction, income eligible for the M&P deduction and the corporation's "aggregate investment income" for the year.

125.1 **Manufacturing And Processing Deduction** is equal to 13% of the lesser of:

A. Manufacturing and processing profits, less amounts eligible for the small business deduction; and

B. Taxable Income, less the sum of:

1. the amount eligible for the small business deduction;
2. 4 times the foreign tax credit for business income calculated without consideration of the ITA 123.4 general rate reduction; and
3. "aggregate investment income" (of CCPCs) as defined in ITA 129(4).

126(1) **Foreign Tax Credits For Corporations** The Foreign Non-Business Income Tax Credit is the lesser of:

- The tax paid to the foreign government (for corporations, there is no 15% limit on the foreign non-business taxes paid); and
- An amount determined by the following formula:

$$\left[\frac{\text{Foreign Non-Business Income}}{\text{Adjusted Division B Income}}\right][\text{Tax Otherwise Payable}]$$

126(2) The Foreign Business Income Tax Credit is equal to the least of:

- The tax paid to the foreign government;
- An amount determined by the following formula:

$$\left[\frac{\text{Foreign Business Income}}{\text{Adjusted Division B Income}}\right][\text{Tax Otherwise Payable}]\text{; and}$$

- Tax Otherwise Payable for the year, less any foreign tax credit taken on non-business income under ITA 126(1).

129(4) **Refundable Portion Of Part I Tax Payable** is defined as the least of three items:

**1.** the amount determined by the formula

A - B, where

A is 30-2/3% of the corporation's aggregate investment income for the year, and

B is the amount, if any, by which the foreign non-business income tax credit exceeds 8% of its foreign investment income for the year.

**2.** 30-2/3% of the amount, if any, by which the corporation's taxable income for the year exceeds the total of:

- the amount eligible for the small business deduction;
- 100 ÷ 38-2/3 of the tax credit for foreign non-business income; and
- 4 times the tax credit for foreign business income.

**3.** the corporation's tax for the year payable under Part I.

129(4) **Aggregate Investment Income** is the sum of:

- net taxable capital gains for the year, reduced by any net capital loss carry overs deducted during the year; and
- income from property including interest, rents, and royalties, but excluding dividends that are deductible in computing Taxable Income. Since foreign dividends are generally not deductible, they would be included in aggregate investment income.

129(4) **ELIGIBLE 2019 Refundable Dividend Tax On Hand** (RDTOH) is defined as follows:

**Beginning Balance** The transitional January 1, 2019 Eligible RDTOH balance which is the lesser of:

- The January 1, 2019 single RDTOH balance; and
- 38-1/3 percent of the January 1, 2019 GRIP balance

**Additions**

- Part IV taxes paid on eligible dividends from non-connected taxable Canadian corporations. These are commonly referred to as portfolio dividends.
- Part IV taxes paid on eligible dividends from connected corporations to the extent that such dividends included a refund from the paying corporation's Eligible RDTOH.

**Deduction** Deducted from this total would be any dividend refund claimed from the Eligible RDTOH account in the previous taxation year. For 2019, this deduction is reflected in the transitional RDTOH balance and will not be deducted again.

**NON-ELIGIBLE 2019 Refundable Dividend Tax On Hand** (RDTOH) is defined as follows:

**Beginning Balance** The transitional January 1, 2019 Non-Eligible RDTOH balance is equal to the excess, if any, of the January 1, 2019 balance in the single RDTOH account, over 38-1/3 percent of the January 1, 2019 GRIP balance.

**Additions** There are three items that are added to the Non-Eligible RDTOH beginning balance:

- All of the Part I refundable tax for the year.
- Part IV taxes paid on non-eligible dividends from connected corporations to the extent that such dividends included a refund from the paying corporation's Non-Eligible RDTOH.
- Part IV taxes paid on non-eligible dividends from non-connected taxable Canadian corporations.

**Deduction** Deducted from this total would be any dividend refund claimed from the Non-Eligible RDTOH account in the previous taxation year. For 2019, this deduction is reflected in the transitional RDTOH and will not be deducted again.

186(1) **Part IV Tax** is assessed at a rate of 38-1/3% of portfolio dividends, plus dividends received from a connected company that gave rise to a dividend refund for the connected company as a result of the payment.

# Tax Related Web Sites

### GOVERNMENT

**Canada Revenue Agency** www.canada.ca/en/revenue-agency
**Department of Finance Canada** www.fin.gc.ca

### CPA FIRMS

**BDO** www.bdo.ca/en-ca/services/tax/domestic-tax-services/overview/
**Deloitte.** www2.deloitte.com/ca/en/pages/tax/topics/tax.html
**Ernst & Young** www.ey.com/CA/en/Services/Tax
**KPMG** www.kpmg.com/ca/en/services/tax
**PricewaterhouseCoopers** www.pwc.com/ca/en/tax/publications.jhtml

### OTHER

**CPA Canada** www.CPAcanada.ca
**Canadian Tax Foundation** www.ctf.ca
**ProFile Tax Suite** www.profile.intuit.ca

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# Study Guide

Your two volume textbook is accompanied by a separate Study Guide that is available in print and online.

The chapters of this Study Guide correspond to the chapters of ***Byrd & Chen's Canadian Tax Principles.***

Each of these Study Guide chapters contains the following:

- Detailed guidance on how to work through the text and problems in the chapter.
- Detailed solutions to the Exercises and Self Study Problems in the textbook for the chapter.
- A list of learning objectives for the material in the chapter.

In addition, the Study Guide contains:

- Two sample personal tax returns and two Self Study Tax Software Problems in Chapters 4 and 11.
- A sample corporate tax return in Chapter 13.
- An extensive Glossary.

# CHAPTER 11

# Taxable Income And Tax Payable For Individuals Revisited

## Introduction

### The Problem

11-1. The subjects of Taxable Income for individuals and Tax Payable for individuals were introduced in Chapter 4. This earlier Chapter provided a general overview of how we arrive at the Taxable Income figure and, in addition, covered in detail the majority of credits that can be applied in the determination of Tax Payable. We chose to cover this material in Chapter 4 in order to enhance your understanding of some of the material dealing with specific types of income in Chapters 5 through 9.

11-2. The problem with this early coverage of these subjects is that there are some concepts and procedures involved in determining Taxable Income and Tax Payable for individuals that cannot be explained without some understanding of the additional components of Net Income For Tax Purposes that are covered in subsequent chapters.

11-3. For example, it is not possible to meaningfully discuss the deduction of loss carry overs in calculating Taxable Income without knowledge of the difference between capital and non-capital losses, a subject that is not covered until Chapter 8. A similar problem arises in dealing with the transfer of dividend tax credits to a spouse. This idea is not comprehensible to an individual who does not have an understanding of the dividend gross up and tax credit procedures which are not introduced until Chapter 7.

### Our Solution

11-4. Our solution to this problem is this second chapter on Taxable Income and Tax Payable for individuals. At this point, we have provided comprehensive coverage of all of the components of Net Income For Tax Purposes. Chapter 3, dealt with employment income, Chapters 5 and 6 dealt with CCA and business income, Chapter 7 provided coverage of property income, and Chapter 8 dealt with taxable capital gains and allowable capital losses. This coverage of income components concluded with Chapter 9's coverage of miscellaneous sources of, and deductions from, Net Income For Tax Purposes.

11-5. With this background, we can now finish our coverage of Taxable Income and Tax Payable for individuals. With respect to Taxable Income, we will provide complete coverage

of both loss carry overs and the lifetime capital gains deduction. We will also be able to deal with the additional credits required in the determination of Tax Payable, as well as the procedures associated with the determination of alternative minimum tax.

# Taxable Income Overview

11-6. As was discussed in Chapter 4, Taxable Income is calculated by deducting certain specified items from Net Income For Tax Purposes. These deductions, which are found in Division C of the *Income Tax Act*, are as follows:

**ITA 110(1)(d), (d.01), and (d.1) - Employee Stock Options** Our basic coverage of stock options and stock option deductions was included in Chapter 3. Adding to this coverage in this Chapter 11, we deal with some special rules that are associated with gifts of shares that have been acquired through the exercise of stock options.

**ITA 110(1)(f) - Deductions For Payments** This deduction is designed to ensure that certain amounts are not subject to tax. Included here are such amounts as social assistance received, workers' compensation received (covered in Chapter 4), and amounts exempted from Canadian tax by tax treaty (covered in Chapter 20). Also included here are deductions for employment income received from certain prescribed international organizations and employment income earned by a member of the Canadian forces serving in certain prescribed missions.

**ITA 110.2 - Lump-Sum Payments** This Section provides a deduction for certain lump-sum payments (e.g., an amount received as a court-ordered termination benefit and included in employment income). It provides the basis for taxing this amount as though it was received over several periods (a.k.a. income averaging). Limited coverage of this provision can be found in the next section of this Chapter.

**ITA 110.6 - Lifetime Capital Gains Deduction** The provisions related to this deduction are very complex and require a fairly complete understanding of capital gains. As a consequence, it was not covered in Chapter 4 and will be given coverage in this Chapter.

**ITA 110.7 - Residing In Prescribed Zone (Northern Residents Deductions)** These deductions, which are limited to individuals living in prescribed regions of northern Canada, were covered in Chapter 4.

**ITA 111 - Losses Deductible** This is a group of deductions that is available for carrying over various types of losses from preceding or subsequent taxation years. The application of these provisions can be complex and requires a fairly complete understanding of business income, property income, and capital gains. As a consequence, this group of deductions was not covered in Chapter 4 and will be covered in detail in this Chapter.

11-7. The material in this Chapter will complete our coverage of Taxable Income for individuals. Of the Taxable Income deductions available to individuals, only amounts exempted by treaty under ITA 110(1)(f) and loss carry overs under ITA 111 are available to corporations. There are, however, additional deductions available to corporate taxpayers for charitable contributions and dividends received from other taxable Canadian corporations. These additional deductions are covered in Chapter 12.

# Lump-Sum Payments

## The Problem

11-8. Individuals sometimes receive lump-sum payments that relate to services provided in one or more previous years. An example of this would be an employment termination payment that included amounts that related to service provided in previous years.

11-9. There is an advantage in such situations in that there has been some deferral of the tax

on these amounts. However, because of the presence of progressive rates in the Canadian tax system, the tax liability on such lump-sum payments may be higher than would have been the case had the payments been received and taxed over multiple years. This would be a particularly severe problem in situations where a very large taxable amount is involved. Because of this problem, there is tax relief available for certain lump-sum payments.

### *Qualifying Amounts*

11-10. The relief can be applied to payments that are referred to as "qualifying amounts". These are given a technical definition in ITA 110.2(1). In the Explanatory Notes that accompany the legislation, the following more general description is found:

> A **qualifying amount** is the principal portion (e.g. not including interest) of certain amounts included in income. Those amounts are: spousal or child support amounts, superannuation or pension benefits otherwise payable on a periodic basis, employment insurance benefits and benefits paid under wage loss replacement plans. Also included is the income received from an office or employment (or because of a termination of an office or employment) under the terms of a court order or judgment, an arbitration award or in settlement of a lawsuit.

### *Relief Mechanism*

11-11. ITA 110.2(2) provides a deduction for the "specified portion" of a "qualifying amount" that was received by an individual during a particular taxation year. The "specified portion" is the fraction of the qualifying amount that relates to an "eligible taxation year". An "eligible taxation year" is any prior year after 1977 in which the individual was a resident of Canada throughout the year and during which the individual did not become bankrupt. No deduction is available if the qualifying amount is less than $3,000. In somewhat simplified terms, this means that an individual can remove the types of payments described as qualifying amounts from the current year's income, to the extent that they relate to prior years.

11-12. ITA 120.31 describes an alternative tax that will be payable on the amounts that are deducted under ITA 110.2(2). This tax is the total of the additional taxes that would have been triggered for each relevant preceding year, if the portion of the qualifying amount that relates to that preceding year was added to the individual's Taxable Income for that year. In addition to the tax for those years, a notional amount of interest is added to reflect the fact that the tax was not paid in the relevant years. This interest is accrued from May 1 of the year following the relevant preceding year, through the end of the year prior to the receipt of the lump-sum payment.

11-13. The goal of these procedures is to spread the lump-sum payment over earlier years, thereby eliminating the influence of progressive rates on the total tax bill. For example, if a 2019 court settlement reflected a wage adjustment for the years 2014 through 2018, the recipient would pay the amount of taxes that would have been paid if he had received the amounts in those earlier years, reduced by the amount of taxes that were paid in those years. In many cases this will provide significant tax relief. However, there may be some situations in which, because of differing marginal tax rates in the years under consideration, using this approach could result in higher taxes because of the addition of the notional amount of interest. In such cases, the taxpayer would not make the deduction under ITA 110.2(2).

# Treatment Of Losses

## Carry Over Provisions

### *General Rules*

11-14. In earlier Chapters there have been references to a taxpayer's ability to carry back or carry forward losses. Before covering the carry over rules related to specific types of losses, we will consider the general procedures associated with these carry overs.

11-15. If a taxpayer experiences a loss in the current year with respect to a particular type of income, it must be used, to the extent possible, to offset other types of income in the current

year. The taxpayer does not have any real discretion in this matter. If he is in a position to apply a loss to other types of income that are available in the loss year and he chooses not to do so, the loss cannot be carried over to either earlier or later years.

11-16. However, there are situations in which one or more losses cannot be used during the current year. There are two basic reasons why this may be the case:

- The taxpayer may not have sufficient other sources of income to absorb the loss (e.g., a business loss that is greater than all other current sources of income).
- The taxpayer may not have sufficient income of the right type to absorb the loss (e.g., an allowable capital loss that is greater than current taxable capital gains).

11-17. If either of these situations arises in the current year, the taxpayer can either carry the loss back to apply against Taxable Income in previous years or, alternatively, carry the loss forward to apply against Taxable Income in future years. Unlike the situation with current year losses, provided that the use is within the specified carry back and carry forward periods, the decision as to when a loss carry over should be used is at the discretion of the taxpayer.

### Carry Backs

11-18. With one exception, all types of current year losses can be applied against income in the three preceding taxation years. The one exception is limited partnership losses which cannot be carried back (see Chapter 18). When the loss is applied, the carry back will result in a refund of some or all of the taxes that were paid in the carry back year.

11-19. Note that, with several types of losses, the carry back amount can only be applied against income of the same type. More specifically:

- Net capital losses can only be applied against net taxable capital gains realized in the carry back year.
- Net listed personal property losses (see Chapter 8) can only be applied against listed personal property gains realized in the carry back year.
- Restricted farm losses (see Chapter 6) can only be applied against farm income realized in the carry back year.

### Carry Forwards

11-20. In general, because of the certainty of a refund, taxpayers will want to carry losses back if there is sufficient income of the appropriate type in any of the three preceding years. While variations in applicable tax rates for the relevant years might generate a situation where a taxpayer might wish to risk carrying an amount forward on the possibility that it would eliminate income that is being taxed at a higher rate in the carry forward period, this is unlikely to be a common choice.

11-21. Any amount of current year loss that is not carried back will become a loss carry forward. Unlike the situation with carry backs, there is some variation in the carry forward period for different types of losses. The current rules are as follows:

> **Non-Capital Losses And Farm Losses** For non-capital and farm losses, the carry forward period is 20 years. Non-capital and regular farm losses can be applied against any type of income in the carry forward year. If the farm loss is restricted, it can only be applied against farm income in the carry forward year.
>
> **Net Capital Losses** Net capital losses can be carried forward indefinitely, limited only by the life of the taxpayer. However, they can only be applied against taxable capital gains that arise in the carry forward year. As will be discussed later in this Chapter, there is an exception for deceased taxpayers who can generally deduct any unused net capital losses against any type of income in the year immediately preceding death and in the year of death. Note that, as this term is used in the *Income Tax Act*, net capital loss refers to the excess of the allowable (one-half) portion of capital losses, over the taxable (one-half) portion of capital gains.

**Net Listed Personal Property Losses** Listed personal property losses can be carried forward for 7 years. As noted previously, they can only be deducted against net listed personal property gains that arise in the carry forward year.

### Segregation By Type

11-22. We have noted that, with both loss carry backs and loss carry forwards, some types of losses can only be applied against income of the same type. Because of this requirement, loss carry forward balances must be segregated by type. More specifically, the separate balances that must be tracked are:

- Non-Capital Losses [employment losses, business losses, property losses, and business investment losses (defined in Paragraph 11-55)]
- Net Capital Losses
- Regular Farm Losses
- Restricted Farm Losses

### Applying The Deduction

11-23. With the exception of listed personal property losses (see coverage beginning in Paragraph 11-31), loss carry overs are deducted from Net Income For Tax Purposes in the determination of Taxable Income.

11-24. In the case of a carry back, there is a reduction of both Taxable Income and Tax Payable in the carry back year. Provided the taxes for that year have been paid, the result will be a refund. As you would expect, the refund will be based on the tax rates applicable to the carry back year.

11-25. With respect to carry forwards, they serve to reduce Taxable Income and Tax Payable in the carry forward year. As was the case with carry backs, the loss carry forward benefit will accrue at the tax rates applicable to the carry forward year.

### Loss Carry Overs And Tax Credits

11-26. You will recall from Chapter 4 that most of the credits against Tax Payable that are available to individuals are not refundable. Further, most of them cannot be carried over to be used in subsequent taxation years. This means that, in the absence of sufficient Tax Payable to absorb these credits, they will be permanently lost.

11-27. These facts relate to loss carry overs in that, given that many tax credits have no value in the absence of a Tax Payable amount, it is generally not advisable to use loss carry overs to reduce Taxable Income to nil in the carry over year.

**EXAMPLE** In 2018, Jan Teason had employment income of $25,000 and a net rental loss of $55,000. She had no reported income in the three preceding years. In 2019, she has no employment income and net rental income of $25,000. Ms. Teason's only tax credit is the basic personal credit of $1,810 [(15%)($12,069)].

**ANALYSIS** In 2018, Ms. Teason had Net Income For Tax Purposes of nil and, at the end of the year, non-capital loss carry forward of $30,000. Note that she did not have the option of reducing the amount of the 2018 rental loss in order to use her personal tax credit.

If she wished to do so, Ms. Teason could reduce her 2019 Taxable Income to nil by applying $25,000 of the 2018 non-capital loss carry forward. However, if she limits her carry forward deduction to $12,931 ($25,000 - $12,069), her Taxable Income will be reduced to $12,069. The tax on this would be $1,810 [(15%)($12,069)], an amount that would be eliminated by her basic personal credit. This approach leaves an unused carry forward balance of $17,069 ($30,000 - $12,931).

11-28. What this example illustrates is that, in practical situations, loss carry overs should not be used to reduce Taxable Income to nil. In the real world, tax preparation software should automatically limit loss carry overs to prevent this from happening. However, trying to build this consideration into the examples and problems included in this text can have the effect of significantly complicating material that is already very difficult to understand. As a result, in some problems we ask that you ignore this issue.

11-29. While this approach is not consistent with real world tax planning considerations, we feel that it can be justified in terms of aiding your understanding of this difficult material on loss carry overs.

## Personal Use Property Losses

11-30. You will recall that personal use property is defined as "property owned by the taxpayer that is used primarily for the personal use or enjoyment of the taxpayer, or for the personal use or enjoyment of one or more individuals related to the taxpayer". As covered in Chapter 8, taxable capital gains on personal use property, determined on the assumption that both the proceeds of disposition and the adjusted cost base are at least $1,000, are included in the calculation of Net Income For Tax Purposes. However, unless the personal use property qualifies as "listed personal property" as described in the following material, losses on personal use property are never deductible.

## Listed Personal Property Losses

### General Rules

11-31. Listed personal property is a designation that has been given to 5 specific categories of personal use property. As listed in ITA 54, these categories are:

- a print, etching, drawing, painting, sculpture, or other similar work of art;
- jewelry;
- a rare folio, rare manuscript, or rare book;
- a stamp; or
- a coin.

11-32. As was the case with personal use property, taxable capital gains on listed personal property are included in Net Income For Tax Purposes, and are also calculated on the assumption that both the proceeds of disposition and the adjusted cost base are at least $1,000 (as noted in Chapter 8, this rule may not be applicable when a charitable donation is involved).

11-33. The difference with these categories of personal use property is that allowable capital losses on listed personal property can be deducted. However, they can only be deducted against taxable capital gains on listed personal property. They cannot be used to reduce taxes on any other type of income, including taxable capital gains on property that is not listed personal property.

### Carry Over Provisions

11-34. If a loss on listed personal property cannot be used in the current year, it can be carried back three years or forward for seven years. In the carry over year, the loss can only be used to the extent that there are gains on listed personal property in that year.

11-35. Unlike other loss carry overs, listed personal property losses are not deducted from Net Income For Tax Purposes in the calculation of Taxable Income. Under ITA 41(2), the net gain on listed personal property is defined as the gains for the current year, reduced by the carry over amounts from the seven preceding years, or the three subsequent years. If this amount is positive, it is added in the calculation of Net Income For Tax Purposes under ITA 3(b). While the process is somewhat different, the final result is the same reduction in Taxable Income that would result from the carry over of some other type of loss.

## Exercise Eleven - 1

**Subject:** Listed Personal Property Losses

During 2018, Mr. Ronald Smothers was unemployed and had no income of any kind. In order to survive, he sold a painting on December 1, 2018 for $89,000. This painting had been left to Mr. Smothers by his mother and, at the time of her death, it had a fair market value of $100,000. During 2019, Mr. Smothers finds a job and has employment income of $62,000. In addition, during June he sells a second painting for $5,000. He had purchased this painting several years ago for $1,000. Determine Mr. Smothers' minimum Net Income For Tax Purposes and Taxable Income for 2019. Indicate the amount and type of any losses available for carry forward at the end of the year. Assume the December 1, 2018 sale had been of publicly traded shares instead of a painting. How would this change your solution?

**SOLUTION available in print and online Study Guide.**

# Non-Capital Losses

## *General Rules*

11-36. In terms of a simple dictionary meaning, the term non-capital would mean any loss other than a loss on the disposition of a capital asset. In fact, in many situations, this non-technical approach would provide the correct result. However, ITA 111(8) contains a very technical definition that must be used in more complex situations in order to ensure that we arrive at the appropriate answer. In simplified form, this definition is as follows:

**ITA 111(8)** The non-capital loss of a taxpayer for a taxation year means the amount determined by the formula:

**A** – **D**, where

**A** is the amount determined by the formula:

**E** – **F**, where

**E** is the total of all amounts each of which is the taxpayer's loss for the year from an office, employment, business or property (including farm losses), the taxpayer's allowable business investment loss for the year, and net capital loss carry overs deducted in the calculation of Taxable Income for the year (this net capital loss amount cannot exceed the taxable capital gains for the year).

**F** is the amount of income determined under ITA 3(c). [Sum of ITA 3(a) non-capital positive sources and ITA 3(b) net taxable capital gains, less Division B, Subdivision e deductions.]

**D** is the taxpayer's farm loss for the year (amount included in E).

11-37. Note that this definition excludes both current year capital losses and farm losses. These two types of losses are subject to different rules and, as a consequence, their balances must be tracked separately. The inclusion of net capital losses in this definition will be explained in our later discussion of net capital losses.

11-38. As can be seen in the definition, non-capital losses can result from the calculation of income from employment, income from a business, or income from property. However, given the limited number of deductions from employment income, it is very unlikely that an individual will experience an employment loss. Normally, non-capital losses would result from the operation of a business or the ownership of property. For example, a non-capital loss on a rental property could occur when expenses associated with the property exceed the rental revenues.

## Exercise Eleven - 2

**Subject:** Non-Capital Losses

During 2019, Janice McMann has net employment income of $35,000, as well as a taxable capital gain of $13,000. In addition, she has a business loss of $58,000 and a farm loss of $2,200. Determine her 2019 non-capital loss.

**SOLUTION available in print and online Study Guide.**

### Carry Over Provisions

11-39. Non-capital losses are defined in ITA 111(8) in such a fashion that a carry over is only available after the current year's income is reduced to nil. Stated alternatively, a carry over is only possible after all current year losses, other than current year capital losses, have been deducted. If losses remain and are available for carry over, they can be applied, at the taxpayer's discretion, to any of the eligible carry over years. However, ITA 111(3) indicates that a non-capital loss carry over for a particular year cannot be used until the available non-capital loss carry overs from all preceding years have been exhausted.

11-40. As we have noted, such losses may be carried back three years and applied against any type of income in those years. If there is not sufficient income in those years to absorb the full amount of these non-capital losses, any remaining balance can be carried forward for a period of 20 years. Whether the amounts are carried back or forward, they will be deducted under ITA 111(1)(a) in the computation of Taxable Income.

## Net Capital Losses

### General Rules

11-41. The term "net capital loss" is defined in ITA 111(8) as the excess of allowable capital losses over taxable capital gains for the current taxation year. Note carefully that, as the term is used in the *Act*, "net capital loss" refers to the deductible portion of capital losses, not to the 100 percent amounts. When these annual amounts are carried forward, the resulting balance is normally referred to as the "net capital loss balance".

### Carry Over Provisions

11-42. While a net capital loss for the current year cannot be deducted in the calculation of the current year's Net Income For Tax Purposes, this amount is available for carry over to other years. Such losses may be carried back three years and forward to any subsequent year.

11-43. When they are carried forward or back, they will be deducted under ITA 111(1)(b) in the calculation of Taxable Income. However, ITA 111(1.1) restricts the deduction of such carry over amounts to the amount included in Net Income For Tax Purposes under ITA 3(b) (net taxable capital gains). Expressed in less technical terms, you can only deduct a net capital loss carry over to the extent that you have net taxable capital gains in the carry over year.

11-44. You will recall from Chapter 8 that the inclusion rate for capital gains has varied over the years. Further, the relevant legislation is such that, when net capital losses are carried over they must be deducted at the rate that is applicable to the carry over year. However, the inclusion rate for capital gains has been one-half since 2000. Given this, our only coverage of situations involving different inclusion rates for capital gains will be in our discussion of net capital losses that are present when a taxpayer dies.

### Conversion Of A Net Capital Loss Carry Over To A Non-Capital Loss Carry Over

11-45. A problem can arise when a taxpayer has a net capital loss carry over, taxable capital gains in the current year, and a current year business or property loss that is large enough to reduce his Net Income For Tax Purposes to nil. As a net capital loss carry over can only be

deducted to the extent of current year net taxable capital gains, the taxpayer usually prefers to use such carry overs whenever current year taxable capital gains are available. A simple example will illustrate this problem.

**EXAMPLE** For 2019, Mr. Waring has property income of $25,000, taxable capital gains of $45,000 [(1/2)($90,000)], and a business loss of $150,000. He also has a net capital loss carry forward from 2018 of $60,000 [(1/2)($120,000)]. He does not anticipate having any further taxable capital gains in the foreseeable future.

11-46. The usual ITA 3 calculation of Net Income For Tax Purposes would be as follows:

| | |
|---|---|
| ITA 3(a) Non-Capital Positive Sources | $ 25,000 |
| ITA 3(b) Net Taxable Capital Gains | 45,000 |
| ITA 3(c) Sum Of ITA 3(a) And 3(b) | $ 70,000 |
| ITA 3(d) Business Loss | ( 150,000) |
| Net Income For Tax Purposes | Nil |

11-47. The business loss reduced Net Income For Tax Purposes to nil and this is a problem for Mr. Waring in that he does not anticipate having further taxable capital gains in the near future. Given this, it would appear that he has lost the ability to use this year's net taxable capital gains to absorb the 2018 net capital loss carry forward.

11-48. Fortunately, this is not the case. You will recall that, in the definition of non-capital loss in Paragraph 11-36, the taxpayer can add to the E component of the definition, any net capital loss carry overs deducted in the current year. This means that, if we assume that Mr. Waring chooses to deduct the maximum amount of his net capital loss carry forward in 2019, the non-capital loss carry over for 2019 would be as follows:

| | |
|---|---|
| Business Loss For Year | $150,000 |
| Net Capital Loss Carry Forward Deducted (Limited To Taxable Capital Gains) | 45,000 |
| Total For Amount E | $195,000 |
| Amount F = Income Under ITA 3(c) ($25,000 + $45,000) | ( 70,000) |
| Non-Capital Loss Available For Carry Over | $125,000 |

11-49. There are two points that should be made with respect to this analysis:

- The amount of the net capital loss carry forward deducted is limited to the $45,000 in net taxable capital gains that were realized during the year. As a result, he has utilized $45,000 of the $60,000 net capital loss carry forward from 2018.
- The deduction of the net capital loss carry over is discretionary. That is, the taxpayer can deduct any amount between $1 and the maximum value of $45,000. In the solution presented, he has deducted the maximum amount, which results in a non-capital loss carry over of $125,000 and leaves a net capital loss carry forward of $15,000 ($60,000 - $45,000). An alternative would have been to deduct none of the net capital loss carry forward, leaving a net capital loss carry forward of $60,000. Under this scenario, the non-capital loss for the year would be calculated as follows:

| | |
|---|---|
| Business Loss For Year (Amount E) | $150,000 |
| Amount F = Income Under ITA 3(c) ($25,000 + $45,000) | ( 70,000) |
| Non-Capital Loss Available For Carry Over | $ 80,000 |

As this calculation illustrates, the combined non-capital and net capital loss total will be the same in these situations, without regard to what amount of the net capital loss is used. If $45,000 of the net capital loss is used, the total loss remaining is $140,000 ($15,000 + $125,000). If none is used, the total is still $140,000 ($60,000 + $80,000). In simple economic terms, this procedure allows the taxpayer to convert a

net capital loss balance with restricted deductibility, into a non-capital loss balance that can be deducted against any type of income.

## Exercise Eleven - 3

**Subject:** Net Capital Loss Carry Overs

During 2018, Ms. Laura Macky had an allowable capital loss of $15,000. Prior to 2019, she had no taxable capital gains and, as a consequence, she has not been able to deduct this loss. In 2019, her income consists of a taxable capital gain of $40,000 [(1/2)($80,000)] and a net rental loss of $30,000. She does not anticipate any future capital gains. Determine Ms. Macky's minimum 2019 Net Income For Tax Purposes and minimum 2019 Taxable Income, as well as the amount and type of any losses available for carry over at the end of the year. Ignore the effects of her tax credits.

**SOLUTION available in print and online Study Guide.**

## Net Capital Losses At Death

11-50. One of the difficulties with net capital loss carry overs is that they can normally only be deducted against taxable capital gains. As there is no time limit on the carry forward of such undeducted losses, an individual can die with a substantial balance of these amounts on hand. Capital losses may also arise in the year of death, either through a disposition prior to death or through a deemed disposition at death.

11-51. ITA 111(2) contains a special provision with respect to both net capital losses from years prior to death and to allowable capital losses arising in the year of death. Essentially, this provision allows these accumulated losses to be applied against any type of income in the year of death, or the immediately preceding year.

11-52. An example will illustrate these provisions:

**EXAMPLE** Ms. Vincent dies in December, 2019. She has a net capital loss carry forward of $25,300 [(1/2)($50,600)]. Her final return has a Net Income For Tax Purposes of $40,000 which includes a taxable capital gain of $4,500 [(1/2)($9,000)]. The only tax credit on her final return is her basic personal tax credit.

**ANALYSIS** If Ms. Vincent was alive, her 2019 taxable capital gain would limit the use of her net capital loss carry forward in 2019. This limitation does not apply in the year of death. To maximize tax savings, her final return should have a Taxable Income of 12,069, the 2019 basic personal amount (see Paragraph 11-27). This means that $27,931 ($40,000 - $12,069) of the net capital loss carry forward should be deducted. This can be applied against any type of income in 2019. The $12,069 can be carried back to 2018 in an amended return and applied against any type of income.

11-53. Capital losses realized by the estate on dispositions of an individual's property in the first taxation year after his death can be carried back and applied against any type of income in the final return of the deceased. Note, however, that these losses cannot be carried back to the tax return for the year preceding death.

11-54. The inclusion rate has been at one-half since 2000. As a result, calculations where an inclusion rate that is not one-half is relevant are increasingly rare. However, we would note the following points:

- If there are taxable capital gains in the year of death, the net capital loss must first be applied at the inclusion rate for the current year to the extent of those gains. If a net capital loss balance remains, ITA 111(2) allows it to be applied against other types of income, using the inclusion rate that prevailed in the year in which the net capital loss was realized.

- The ability to use this provision is reduced by the previous deduction of amounts under the lifetime capital gains provision (see discussion later in this Chapter). This reduction reflects the actual amount of the lifetime capital gains deduction made, without regard to the capital gains inclusion rate that was applicable at the time.

## Exercise Eleven - 4

**Subject:** Net Capital Losses At Death

Mr. Derek Barnes dies during 2019. He has a net capital loss carry forward of $20,000 [(1/2)($40,000)] at the time of his death. His final return has a Net Income For Tax Purposes of $23,800 which includes a taxable capital gain of $9,200 [(1/2)($18,400)]. The only tax credit on his final return is his basic personal tax credit. Describe the optimal tax treatment of Derek's net capital loss carry forward.

**SOLUTION available in print and online Study Guide.**

## Allowable Business Investment Losses

### *Defined*

11-55. A Business Investment Loss (BIL), as defined in ITA 39(1)(c), is a special type of capital loss resulting from the disposition of shares or debt of a "small business corporation". In addition to losses on arm's length sales, business investment losses can be incurred when there is a deemed disposition for nil proceeds. This could occur for shares of a small business corporation due to bankruptcy or insolvency, or if the debt is considered uncollectible.

11-56. A small business corporation is defined in ITA 248(1) as a Canadian controlled private corporation (CCPC) of which "all or substantially all", of the fair market value of its assets are used in an active business carried on "primarily" in Canada. In tax work, the term "substantially all" generally means 90 percent or more, while "primarily" is generally interpreted to mean more than 50 percent.

11-57. In making this determination, shares or debt of a connected small business corporation would count towards the required 90 percent. A corporation is connected if the potential small business corporation either controls it, or owns more than 10 percent of its voting shares and shares that represent more than 10 percent of the fair market value of all of the corporation's outstanding shares. As you would expect, an Allowable Business Investment Loss (ABIL) is the deductible one-half of a BIL.

### *Special Treatment*

11-58. In general, allowable capital losses can only be deducted against taxable capital gains. However, ABILs are given special treatment in that the taxpayer is permitted to deduct these amounts from any source of income.

> **EXAMPLE** An individual with net employment income of $50,000 has an ABIL of $10,500 [(1/2)($21,000)].
>
> **ANALYSIS** This individual would be able to deduct the $10,500 ABIL against the employment income, resulting in a Net Income For Tax Purposes of $39,500. If this had been an ordinary allowable capital loss, the taxpayer's Net Income For Tax Purposes would be $50,000 and the unapplied allowable capital loss would become a net capital loss for the year which would be available for carry over to other years.

11-59. If there is sufficient income, the ABIL must be deducted in the year in which it is realized. However, if other sources of income are not sufficient for deducting all or part of an ABIL under ITA 3(d) in the current year, it becomes a part of the non-capital loss carry over balance. This permits this special type of allowable capital loss to be deducted against any type of income when they are carried back or carried forward.

11-60. If the ABIL has not been applied during the 10 years subsequent to its occurrence, it reverts to its original status as an allowable capital loss and becomes a component of the net capital loss carry forward balance. While this restricts the types of income that the loss can be applied against, it gives the loss an unlimited carry forward period.

### Effect Of The ITA 110.6 Lifetime Capital Gains Deduction

11-61. As we shall see in our discussion of the ITA 110.6 lifetime capital gains deduction, beginning in Paragraph 11-68, the realization of a Business Investment Loss reduces the taxpayer's ability to take advantage of this deduction. Of note here, however, is the fact that under ITA 39(9), Business Investment Losses are disallowed by the use of the ITA 110.6 lifetime capital gains deduction. What this means is, to the extent that the individual has made a deduction under ITA 110.6, an equivalent portion of the Business Investment Loss will be disallowed (i.e., converted to an ordinary capital loss).

**EXAMPLE** Mr. Mercer had a taxable capital gain in 2012 of $8,000 [(1/2)($16,000)] and deducted this amount under the provisions of the ITA 110.6 lifetime capital gains deduction. In July, 2019, he has a $60,000 loss on the sale of shares of a small business corporation. Mr. Mercer has no capital gains or losses in any other year.

**ANALYSIS** If Mr. Mercer had made no use of ITA 110.6, he would have an allowable business investment loss of $30,000 [(1/2)($60,000)] in 2019. However, since he has made a deduction under ITA 110.6, the business investment loss would be reduced as follows:

| | |
|---|---|
| Actual Loss On Disposition | $60,000 |
| Disallowed By Lifetime Capital Gains Deduction Use | ( 16,000) |
| Business Investment Loss | $44,000 |
| Inclusion Rate | 1/2 |
| Allowable Business Investment Loss (ABIL) | $22,000 |

11-62. As we have noted, the disallowed $16,000 does not disappear. It becomes an ordinary capital loss, subject to the usual restriction that it can only be deducted against capital gains. The remaining $22,000 ABIL can be deducted in 2019 against any source of income. If it is not deducted in that year or carried back, it becomes part of the non-capital loss carry forward for 10 (not 20) years. If it is still not used after 10 years, in year 11, it becomes part of the net capital loss carry forward.

## Exercise Eleven - 5

**Subject:** Business Investment Losses

During 2018, Mr. Lawrence Latvik used his lifetime capital gains deduction to eliminate a taxable capital gain of $13,000 [(1/2)($26,000)]. During 2019, he has capital gains on publicly traded securities of $18,000, and a loss of $50,000 on the disposition of shares of a small business corporation. His employment income for 2019 is over $200,000. Determine the amount of the Allowable Business Investment Loss that can be deducted in 2019, as well as the amount and type of any losses available for carry over at the end of the year.

**SOLUTION available in print and online Study Guide.**

**We suggest you work Self Study Problem Eleven-1 at this point.**

## Farm Losses

### Regular Farm Losses

11-63. For full time farmers, farm losses are not restricted. They are treated in the same manner as non-capital losses in that they can be carried back 3 years and forward for 20 years. Unlike restricted farm losses (see the following Paragraph), when they are deducted on a carry over basis, regular farm losses can be applied against any type of income.

### Restricted Farm Losses

11-64. As noted in Chapter 6, if a farm operation does not have a reasonable expectation of profit (the so-called hobby farm), none of the losses associated with the operation will be deductible. However, even if there is a reasonable expectation of profit, farm losses may be restricted. More specifically, under ITA 31, farm losses are restricted if:

> ... a farmer's chief source of income for a taxation year is neither farming nor a combination of farming and some other source of income that **is a subordinate source of income** for the taxpayer ...

11-65. In effect, if farming is only a secondary source of income, farm losses will be restricted, even if the farming operation has a reasonable expectation of a profit. The restriction limits losses that can be deducted against other sources of income to the first $2,500 of such losses, plus one-half of the next $30,000, for a maximum deduction of $17,500 [$2,500 + (1/2) ($32,500 maximum - $2,500)] on farm losses of $32,500 or greater. Any amount of the farm loss that is not deductible in the current year is commonly referred to as a "restricted farm loss".

11-66. Restricted farm losses can be carried over to other years. Such losses can be carried back 3 years and forward for a maximum of 20 years. In carry over periods, restricted farm losses can only be deducted to the extent that income from farming has been included in Net Income For Tax Purposes. For example, if a restricted farm loss carry forward of $15,000 was available at the beginning of 2019 and 2019 farming income totaled $12,000, only $12,000 of the carry forward could be deducted in calculating 2019 Taxable Income. The remaining $3,000 of the restricted loss could not be deducted, even if the taxpayer had large amounts of other types of income available.

11-67. If land used in a farming business is disposed of before the taxpayer has an opportunity to fully utilize restricted farm losses carried forward, a part of the undeducted losses can be used to increase the adjusted cost base of the property. This would have the effect of reducing any capital gains arising on the disposition of the property. This treatment is only possible to the extent that the loss was created by property taxes or interest payments on the farm property.

### Exercise Eleven - 6

**Subject:** Farm Losses

Ms. Elena Bodkin has a full time appointment as a professor at a Canadian university. As she has considerable free time, she is developing an organic vegetable farm. In 2018, the first year of operation, she had a loss of $36,000 and deducted the maximum allowable amount. In 2019, in addition to her employment income of $85,000, her farming operation showed a profit of $3,500. Determine Ms. Bodkin's minimum 2019 Net Income For Tax Purposes and Taxable Income, as well as the amount and type of any losses available for carry forward at the end of the year.

**SOLUTION available in print and online Study Guide.**

**We suggest you work Self Study Problem Eleven-2 at this point.**

# Lifetime Capital Gains Deduction

## Background

### The Original Legislation

11-68. The lifetime capital gains legislation was first introduced in 1985 and, in its original form, it allowed every individual resident in Canada to enjoy up to $100,000 in tax free capital gains during the course of their lifetime. This privilege was available without regard to the type of property on which the gain accrued. A resident Canadian could acquire a major tax benefit through the process of owning and disposing of a Florida condominium. This original legislation was modified in 1988, providing an enhanced $500,000 deduction for shares in qualified small business corporations and for qualified farm properties.

### Limiting Its Scope

11-69. Without reviewing the long history of this legislation, changes to the original legislation have limited the use of this valuable deduction to dispositions involving qualified farm properties, qualified fishing properties, and shares of qualified small business corporations. These changes left in place a number of issues related to determining the adjusted cost base of assets that had previously qualified for the deduction. However, at this time, these issues are no longer of sufficient importance to warrant coverage in a general text such as this.

## Current And Future Limits

11-70. As of 2019, the deduction limit for dispositions of shares of qualified small business corporations is $866,912. This is an indexed figure that was established at $800,000 in 2014 and is indexed each year for inflation. The available deduction for qualified farm property and qualified fishing property was increased to $1,000,000 for dispositions after April 20, 2015. The $1,000,000 limit will remain unchanged until the indexed limit for qualified small business shares exceeds $1,000,000. At that time the same indexed figure will apply to all types of qualified property. For 2019, the extra amount for farm or fishing properties is $133,088 ($1,000,000 - $866,912).

11-71. You should note that the limits are cumulative for all three types of qualified property. That is, you do not get $866,912 for qualified small business shares and an additional $1,000,000 for qualified farm and fishing property. Given that we have two different limits, there is a problem in applying a cumulative limit. The solution is that gains on all three types of qualified property are accumulated until they reach the indexed figure ($866,912 for 2019). To go beyond this to the $1,000,000 limit, only gains on dispositions of farm or fishing property are eligible, even if gains on these types of property are included in the first $866,912.

> **EXAMPLE** In 2018, Mary Geary has a $500,000 gain on a qualified farm property and a $300,000 gain on shares of a qualified small business corporation. In October, 2019, Mary has a $75,000 gain on a qualified farm property and a $100,000 gain on shares of a qualified small business corporation.
>
> **ANALYSIS** In 2018, both gains, a total of $800,000, would qualify for the lifetime capital gains deduction. In 2019, only $66,912 of the gain on the qualified small business shares could be eliminated through the use of the lifetime capital gains deduction. The remaining $33,088 ($100,000 - $66,912) would not be eligible as it exceeds the indexed limit for qualified small business shares. However, the $75,000 gain on the qualified farm property could be eliminated with the lifetime capital gains deduction, bringing the total claimed to $941,912 ($800,000 + $66,912 + $75,000).

## Qualified Property

### Types Of Property

11-72. The ITA 110.6 lifetime capital gains deduction is available on a disposition of shares of a qualified small business corporation, and interests in qualified farm and fishing

properties. As it is the most common application of this provision, we will focus our attention on shares of qualified small business corporations. With respect to the other two types of qualified property, they can be generally described as follows:

**Qualified Farm or Fishing Property** Qualified farm property and qualified fishing property are defined in ITA 110.6(1). They include real property and eligible capital property used in Canada for farming or fishing by a taxpayer, the taxpayer's spouse, or their children. The definition also includes a share of a family farm or fishing corporation and an interest in a family farm or fishing partnership. To qualify, during the 24 months preceding the disposition, the property must not be owned by anyone other than the selling taxpayer, his spouse or common-law partner, his children or his parents.

### Small Business Corporations

11-73. As noted in our discussion of Business Investment Losses in Paragraph 11-55, ITA 248(1) defines a small business corporation as a Canadian controlled private corporation (CCPC) of which all, or substantially all (90 percent or more), of the fair market value of its assets are used in an active business carried on primarily (more than 50 percent) in Canada. In order to be a qualified small business corporation for the purposes of the lifetime capital gains deduction, the corporation is only required to satisfy this definition of a small business corporation at the point in time at which the shares are sold.

11-74. In many cases this is not a difficult criterion to satisfy. If, at a particular point in time, less than 90 percent of the fair market value of the corporation's assets are involved in producing active business income, it is often a simple matter to sell some of the non-qualifying assets and distribute the proceeds to the shareholders. This process, commonly referred to as "the purification of a small business corporation", can normally be carried out in a short period of time, thereby satisfying the small business corporation criteria prior to the disposition of the shares.

### Qualified Small Business Corporations

11-75. Not all small business corporations are qualified small business corporations. To achieve this stature, ITA 110.6(1) requires that two other conditions be met. In somewhat simplified terms, they are:

- the shares must not be owned by anyone other than the taxpayer or a related person for at least 24 months preceding the disposition; and
- throughout this 24 month period, more than 50 percent of the fair market value of the corporation's assets must be used in an active business carried on primarily in Canada.

11-76. There are additional rules that are applicable when intercorporate investments are involved in the preceding determinations. More specifically, additional requirements apply when the condition that 50 percent of the assets must be used in active business for a 24 month period can only be met by adding in the shares of another small business corporation. These special rules go beyond the scope of this text and, as a result, will not be covered here.

11-77. As compared to meeting the small business corporation criteria, a failure to meet these additional qualifying criteria is more difficult to correct. As they involve measurements made over a period of time, a failure to satisfy them can only be corrected by the passage of time.

## Determining The Deductible Amount

### General Rules

11-78. The determination of the amount of the lifetime capital gains deduction that can be deducted in a year involves calculations that can be complex. In general terms, the available deduction is the least of the following three items:

- Capital Gains Deduction Available
- Annual Gains Limit
- Cumulative Gains Limit

11-79. These items will be explained in detail in the following material.

## Capital Gains Deduction Available

11-80. The "capital gains deduction available" is the lifetime maximum for the capital gains deduction, less any amounts that have been used up in preceding years. As discussed and illustrated with an example in Paragraph 11-71, there are two limits:

- For shares of qualified small business corporations, the limit for 2019 is $433,456 [(1/2)($866,912)].
- For qualified farm and fishing properties the limit is $500,000 [(1/2)($1,000,000)].

11-81. A problem can arise in determining the amounts used up in years prior to 2000. Clearly, it would not be appropriate to subtract a $12,000 deduction made in 1990 which represented the taxable three-quarters of a $16,000 capital gain, from the 2019 limit of $433,456, which is based on one-half of the limit. However, as noted in Paragraph 11-44, the inclusion rate has been at one-half since 2000. Given this, we will not complicate our lifetime capital gains deduction calculations with this issue as it is now much less common.

## Annual Gains Limit

11-82. The annual gains limit is defined in ITA 110.6(1) as follows:

> **Annual Gains Limit** of an individual for a taxation year means the amount determined by the formula
>
> **A** – **B**, where
>
> **A** is equal to the lesser of:
>
> - net taxable capital gains for the current year on all capital asset dispositions [ITA 3(b)]; and
> - net taxable capital gains for the current year on dispositions of qualified farm property, qualified fishing property, and qualified small business corporation shares.
>
> **B** is equal to the total of:
>
> - The amount, if any, by which net capital loss carry overs deducted for the year under ITA 111(1)(b), exceeds the excess of net taxable capital gains for the year [ITA 3(b)] over the amount determined in Part A of this formula; and
> - Allowable Business Investment Losses realized during the current year.

11-83. The annual gains limit formula is made complex by the possibility of having a capital gain on an asset that is not eligible for the deduction in the same year that there is a capital gain on a qualified property. In a year in which there is a capital gain on a qualified property and no other capital gains, the formula can be stated more simply as follows:

> **Annual Gains Limit** is equal to the taxable capital gains on qualified property, less:
>
> - Allowable capital losses realized.
> - Net capital loss carry overs deducted.
> - Allowable Business Investment Losses realized.

11-84. We will make use of this abbreviated formula when the only capital gains during the year are those on qualified property.

11-85. Additional points here are as follows:

- With respect to the Allowable Business Investment Losses realized, the full amount is subtracted in the preceding formula, without regard to whether they have been deducted in the calculation of Net Income For Tax Purposes. Also keep in mind that

the amount of Allowable Business Investment Losses realized is based only on those amounts that have not been disallowed by the previous use of the lifetime capital gains deduction.

- As a further point here, the deduction of net capital loss carry forwards is discretionary. This means that, in cases where there is the possibility of using either the lifetime capital gains deduction or a net capital loss carry forward, the individual must choose between the two alternatives. This is inherent in the annual gains limit formula which, in most situations, will reduce the limit on a dollar for dollar basis for net capital loss carry overs deducted.

While this choice between the two alternatives may have no influence on the current year's Taxable Income, we would suggest a preference for making maximum use of the lifetime capital gains deduction. There is no time limit on using the net capital loss carry forward and, more importantly, it can be used when any type of taxable capital gain is realized. In contrast, the lifetime capital gains deduction can only be used for particular types of capital gains.

## Exercise Eleven - 7

**Subject:** Annual Gains Limit

On January 1, 2019, your client, Miss Jana Slovena, has a net capital loss carry forward from 2017 of $45,000. During 2019, Miss Slovena has the following:

- taxable capital gains on sales of real estate in the amount of $114,000
- allowable capital losses of $82,000
- a taxable capital gain of $42,000 on sales of shares in a qualified small business corporation
- an Allowable Business Investment Loss of $3,000 on sales of shares of a small business corporation that does not qualify for the lifetime capital gains deduction

As she does not expect to have additional capital gains in the near future, Miss Slovena has asked you to deduct the full $45,000 of the 2017 net capital loss during 2019. Determine her annual gains limit for 2019 using this approach. What advice would you give Ms. Slovena regarding her net capital loss?

**SOLUTION available in print and online Study Guide.**

### Cumulative Net Investment Loss (CNIL)

11-86. Many individuals who have high income, invest in products that are, in general, referred to as tax shelters. Such products include limited partnerships, certain types of investments in resource properties and, in some situations, real estate. These investments, while producing positive overall results for investors, also generate significant tax savings. Hence, the name tax shelter. The government concluded that it was inequitable for individuals to simultaneously deduct such investment losses while sheltering capital gains through the use of the lifetime capital gains deduction. As a result, the legislation restricts the use of the lifetime capital gains deduction by an individual's Cumulative Net Investment Losses (CNIL).

11-87. CNIL is defined as the amount by which the aggregate of investment expenses for the current year and prior years ending after 1987, exceeds the aggregate of investment income for that period. That is, the CNIL consists of post-1987 investment expenses minus investment income. You should note that, in this context, both investment income and investment expense are defined in the *Income Tax Act*. As a consequence, they have a meaning that can be different from the meaning associated with the everyday use of these terms.

11-88. As will be explained in the following material, individuals who have a CNIL will have their ability to use the lifetime capital gains deduction reduced. As a result, if qualified capital gains are anticipated, it is advantageous to minimize any CNIL. Some examples of ways in which the impact of the CNIL can be reduced are as follows:

- Realizing capital gains on qualified assets early, if Cumulative Net Investment Losses are anticipated in future years.
- Delaying the disposition of qualified assets with accrued capital gains until the CNIL has been eliminated or reduced as much as possible.
- For owner/managers, having their corporation pay dividends or interest on shareholder loan accounts, rather than salaries, to increase investment income.

### *Cumulative Gains Limit*

11-89. In somewhat simplified form, the cumulative gains limit can be defined as follows:

The sum of all annual gains limits for the current and previous years, unadjusted for changes in the capital gains inclusion rate. This total is reduced by:

- The sum of all amounts deducted under the lifetime capital gains deduction provision in computing the individual's taxable incomes for preceding taxation years (unadjusted for changes in the capital gains inclusion rate); and
- the individual's CNIL at the end of the year.

11-90. In the absence of a CNIL balance, this formula would simply be the sum of all annual gains limits, reduced by all of the lifetime capital gains deductions made in previous years. As individuals will normally deduct the full amount of their annual gains limit, this balance will usually be equal to the annual gains limit for the current year. This result can be altered by an individual's failure to deduct the full amount of the annual gains limit in some previous year, either as a tax planning choice or as the result of a CNIL balance.

11-91. The following is a simple example of cumulative gains limit calculations.

**EXAMPLE** In 2019, Ms. Nolan has $5,600 of deductible interest on loans for investment purposes and $2,600 of net rental income. She has had no investment income or investment expenses in years prior to 2019, so her Cumulative Net Investment Loss (CNIL) is $3,000 ($5,600 - $2,600). During August, 2019, she has a $60,000 taxable capital gain on the sale of shares in a qualified small corporation. Ms. Nolan has no other capital gains or losses in 2019.

**ANALYSIS** As she has made no previous use of her lifetime capital gains deduction, her unused lifetime limit for qualified small business shares is $433,456. While her annual gains limit would be $60,000, the amount of the taxable capital gain, her ability to use the lifetime capital gains deduction would be reduced by her CNIL as her cumulative gains limit is only $57,000 ($60,000 - $3,000).

## Comprehensive Example

11-92. The example that follows illustrates the basic rules involved in the application of the lifetime capital gains deduction.

**EXAMPLE** Dwight Treadway's 2019 Net Income For Tax Purposes is as follows:

| | |
|---|---|
| Employment Income | $ 60,000 |
| Taxable Capital Gain On The Sale Of Shares In A Qualified Small Business Corporation | 200,000 |
| Net Income For Tax Purposes | $260,000 |

In 2013, Mr. Treadway realized a $20,000 taxable capital gain [(1/2)($40,000)] from the sale of shares in a qualified small business corporation and used his lifetime capital gains deduction to claim a deduction for this amount. In 2012, Mr. Treadway realized

an allowable capital loss of $9,000 [(1/2)($18,000)]. He was not able to use the loss in that year, or any other year, and he intends to deduct it as a net capital loss carry forward in 2019. Other than the 2013 taxable capital gain of $20,000 and the 2012 allowable capital loss of $9,000, Mr. Treadway had no capital gains, capital losses, loss carry overs, or Business Investment Losses from 2012 through 2019. He has no CNIL balance in 2019.

**ANALYSIS** For 2019, the maximum deduction under ITA 110.6 would be the least of the following amounts:

- **Capital Gains Deduction Available = $413,456** ($433,456 - $20,000).
- **Annual Gains Limit = $191,000** As Mr. Treadway has had no capital gains on non-qualified property in 2019, we can use the simplified version of this calculation. (See Paragraph 11-83.) This would result in an annual gains limit of $191,000, the $200,000 taxable capital gain for the year, less the 2012 net capital loss carry forward of $9,000 deducted under ITA 111(1)(b).
- **Cumulative Gains Limit = $191,000** As the annual gains limit for 2013 would be equal to the $20,000 taxable capital gain on qualifying property, the sum of the annual gains limits would be $211,000 ($20,000 + $191,000). Subtracting from this the $20,000 lifetime capital gains deduction for 2013 leaves the cumulative gains limit of $191,000.

11-93. Given these calculations, the maximum deduction for 2019 would be $191,000, the amount of both the annual gains limit and the cumulative gains limit. The full $200,000 gain on the shares could have been deducted if Mr. Treadway had not chosen to deduct the net capital loss carry forward. The deduction of this amount reduced both the annual gains limit and the cumulative gains limit by $9,000. It would be advisable for Mr. Treadway not to deduct any of the net capital loss carry forward. If he did this, his annual gains limit would increase to $200,000. Although he would have used $9,000 more of his lifetime capital gains deduction, his tax liability for 2019 would not change and he would still have a net capital loss carry forward of $9,000 that could be applied against any type of capital gain for an unlimited period of time.

## Exercise Eleven - 8

**Subject:** Lifetime Capital Gains Deduction (ITA 110.6 Deduction)

Mr. Edwin Loussier had a 2012 taxable capital gain on shares of a qualified small business corporation of $5,000 [(1/2)($10,000)] and a 2014 taxable capital gain on shares of a qualified small business corporation of $13,000 [(1/2)($26,000)]. He used his ITA 110.6 lifetime capital gains deduction to eliminate both of these gains. He has no other capital gains, capital losses, or Business Investment Losses in the period 2012 through 2017. In December, 2018, he has a $63,000 capital loss which, because he has no capital gains in that year, he cannot deduct. In 2019, he has a $510,000 capital gain on the sale of shares of a qualified small business corporation. In addition, he deducts the $63,000 capital loss from 2018. Mr. Loussier does not have a CNIL balance. Determine Mr. Loussier's maximum lifetime capital gains deduction for 2019. Provide all of the calculations required to determine the maximum ITA 110.6 deduction.

**SOLUTION available in print and online Study Guide.**

**We suggest you work Self Study Problem Eleven-3 at this point.**

# Ordering Of Deductions And Losses

## Significance Of Ordering

11-94. If an individual has sufficient income to absorb all of the losses and deductions that are available in the calculation of Taxable Income, the question of ordering is not important. The real significance of provisions covering the ordering of losses and other deductions is in the determination of the amounts and types of items that can be carried over to previous or subsequent years.

11-95. For example, assume that a taxpayer has taxable capital gains of $25,000, a business loss of $25,000, and allowable capital losses of $25,000. No matter how these items are ordered, the Net Income For Tax Purposes will be nil. However, it does make a difference whether the loss carry over is for the business loss, or for the net capital losses. A net capital loss carry forward can only be deducted to the extent of taxable capital gains in the carry forward period. On the other hand, the non-capital losses can only be used for a limited period of time (20 years) while, by contrast, the net capital losses can be carried forward indefinitely. Note, however, with a time limit of 20 years, having a limited carry forward period of this length is not likely to be a significant factor in most situations.

## Ordering In Computing Net Income For Tax Purposes

11-96. The basic rules for the computation of Net Income For Tax Purposes under Division B are found in ITA 3. In computing Net Income For Tax Purposes, ITA 3 indicates that we begin by adding together positive amounts of income from non-capital sources, plus net taxable capital gains. Net taxable capital gains are defined as the amount, if any, by which the current year's taxable capital gains exceed the current year's allowable capital losses. This, in effect, requires that capital losses, to the extent there are capital gains during the year, be deducted prior to the deduction of any other type of loss.

11-97. The various deductions available under Subdivision e (RRSP deductions, spousal support paid, child care costs, moving expenses, etc.) are subtracted from this total. If a positive balance remains, the final step in computing Net Income For Tax Purposes is to subtract any employment, business, or property losses, as well as Allowable Business Investment Losses. If this process does not seem familiar to you, you might want to review the material on ITA 3 that is contained in Chapter 1.

## Ordering In Computing Taxable Income

11-98. The ordering rules in ITA 3 are applicable to all taxpayers - individuals, corporation and trusts. Further, they are not discretionary. Items that occur during a given taxation year, must be added or deducted in that year. In contrast, the ordering rule in ITA 111.1 only applies to individuals. Under this rule, the order in which Division C items must be deducted is as follows:

- Various deductions provided by ITA 110 (e.g., stock options)
- Retroactive lump-sum payments under ITA 110.2
- Loss carry overs under ITA 111 (non-capital, net capital and farm)
- Lifetime capital gains deduction under ITA 110.6
- Northern residents deductions under ITA 110.7

11-99. Within ITA 111 (loss carry overs), available amounts can be deducted in any order the taxpayer wishes. The only constraint is the ITA 111(3)(b) requirement that, within a particular type of loss (e.g., non-capital losses), the oldest losses have to be deducted first.

11-100. When several different types of loss carry overs are available, decisions in this area can be difficult. On the one hand, certain types of carry overs have a limited period of availability (i.e., non-capital losses and farm losses can be carried forward for 20 years). In contrast, net capital losses have no time limit, but can only be deducted to the extent of taxable capital gains that have been realized in the year. Restricted farm loss carry overs and

carry overs of losses on listed personal property have more onerous limitations. These losses are restricted with respect to both time and type of income (e.g., restricted farm loss carry forwards are available for 20 years and can only be deducted to the extent of farm income earned in the year).

11-101. Decisions in this area will involve a careful weighing of which type of loss carry over is most likely to have continued usefulness in future years. For example, if a non-capital loss carry forward is 19 years old and the business is expecting no Taxable Income in the following year, then use of this carry forward would appear to be a prudent course of action. An additional constraint is that the deduction of loss carry overs should leave sufficient Taxable Income that Tax Payable does not become less than the amount of available tax credits. As discussed in Paragraph 11-26 through 11-29, tax credits that are not used during the current taxation year are, in general, permanently lost.

## Example

11-102. The following is an example of the ordering rules used in computing Taxable Income for individuals:

**EXAMPLE** At the beginning of 2019, Miss Farnum had the following loss carry forwards available:

| | |
|---|---|
| Non-Capital Losses | $40,000 |
| Net Capital Losses [(1/2)($20,000)] | 10,000 |
| Restricted Farm Losses | 5,000 |

For 2019, she can claim only the basic personal amount of $12,069. Also during 2019, she has no available subdivision e deductions. For this year, she had the following income amounts as calculated under Division B rules:

| | |
|---|---|
| Employment Income | $15,000 |
| Property Income (Interest) | 4,000 |
| Farm Income | 2,000 |
| Income From Sole Proprietorship | 15,000 |
| Capital Gains | 12,000 |

**ANALYSIS** Miss Farnum's 2019 Net Income For Tax Purposes and Taxable Income would be calculated as follows:

| | | |
|---|---|---|
| Income Under ITA 3(a): | | |
| Employment Income | $15,000 | |
| Property Income | 4,000 | |
| Farming Income | 2,000 | |
| Business Income (Proprietorship) | 15,000 | $36,000 |
| Income Under ITA 3(b): | | |
| Taxable Capital Gains [(1/2)($12,000)] | | 6,000 |
| **Net Income For Tax Purposes** | | **$42,000** |
| Restricted Farm Loss Carry Forward (Limited to farming income) | | ( 2,000) |
| Net Capital Loss Carry Forward (Limited to taxable capital gains) | | ( 6,000) |
| Subtotal | | $34,000 |
| Non-Capital Loss Carry Forward ($34,000 - $12,069) | | ( 21,931) |
| **Taxable Income = Basic Personal Amount** | | **$12,069** |

**Loss Carry Forwards**

| | |
|---|---|
| • Restricted farm loss carry forward ($5,000 - $2,000) | $ 3,000 |
| • Net capital loss carry forward ($10,000 - $6,000) | 4,000 |
| • Non-capital loss carry forward ($40,000 - $21,931) | 18,069 |

11-103. Note that, in this example, the amount of net capital and restricted farm losses deducted was limited by the amount of the taxable capital gains and farm income. The non-capital loss deducted was limited to the amount that would reduce her Taxable Income to her basic personal amount of $12,069. Since her Tax Payable will be nil at this point, there is no reason to deduct any further amount of the non-capital loss available.

### Exercise Eleven - 9

**Subject:** Ordering Of Losses

At the beginning of 2019, Alan Barter had the following loss carry forwards available:

| | |
|---|---|
| Restricted Farm Losses | $ 8,000 |
| Non-Capital Losses | 36,000 |
| Net Capital Losses [(1/2)($40,000)] | 20,000 |

During 2019, he had the following amounts of income:

| | |
|---|---|
| Taxable Capital Gains | $ 9,000 |
| Business Income | 12,000 |
| Employment Income | 56,000 |
| Farm Income | 3,500 |

Determine Alan's Net Income For Tax Purposes, as well as his minimum Taxable Income for 2019. Indicate the amount and type of any losses available for carry forward at the end of the year.

**SOLUTION available in print and online Study Guide.**

# Tax Payable Overview

## General

11-104. Chapter 4 provided detailed coverage of the application of federal tax rates to Taxable Income in order to provide an initial figure for an individual's Tax Payable. In addition, coverage of most of the tax credits available to individuals was provided. The coverage of tax credits was extended in Chapter 7 with coverage of the dividend tax credit, as well as the credit for taxes withheld on foreign source income.

11-105. None of this material will be repeated in this Chapter. However, as many of the Self Study and Assignment Problems that accompany this Chapter are comprehensive in nature and will require you to apply tax calculations and credits, you might wish to review the material in Chapters 4 and 7 before working the problems in this Chapter.

11-106. As was the case with the material on Taxable Income, there are issues involved with the determination of Tax Payable for individuals that could not be dealt with in Chapter 4 because of the need to understand income concepts not presented until subsequent chapters. As a result, additional coverage of Tax Payable is included in this Chapter. Specifically, the following concepts and procedures are discussed in this material:

**Tax On Split Income (TOSI)** This is a special tax, assessed at the maximum federal rate of 33 percent on certain types of income received from a related source. It was originally designed to limit income splitting to minor children. However, as of 2018 it has been extended to cover related adults.

**Transfer Of Dividends To A Spouse Or Common-Law Partner** The calculations related to this tax credit require an understanding of the dividend gross up and tax credit procedures which were not introduced until Chapter 7.

**Charitable Donations** The basic calculation of this tax credit was presented in Chapter 4. However, it was not possible to deal with gifts of capital property until the material in Chapters 5 through 8 on business income, property income and capital gains had been covered.

**Foreign Tax Credits** These credits were introduced in Chapter 7. However, the full determination of the eligible amounts requires the additional material on Taxable Income that is included in this Chapter.

11-107. Now that we have covered the material in Chapters 5 to 10, we are in a position to complete our coverage of the determination of Tax Payable for individuals.

## Basic Federal Tax Payable

11-108. Basic federal Tax Payable is a figure from which some, but not all tax credits have been deducted. At one time, this was an important figure in that it was the base that the provinces and territories used in calculating their respective provincial Tax Payable. Since the provinces now base provincial taxes on Taxable Income, the basic federal tax figure is no longer of general importance.

11-109. This concept does have some limited use in specialized situations and, because of this, you will see references to this figure in the T1 tax return. The most important of these is that it is used to calculate the additional federal Tax Payable that must be paid by individuals who are deemed Canadian residents but do not reside in a province (e.g., members of the Canadian Armed Forces stationed outside of Canada). However, other than indicating that this concept exists, we will give basic federal Tax Payable no further consideration.

# Tax On Split Income (TOSI)

## A Note Of Caution

11-110. The 2000 introduction of the TOSI had a very dramatic impact on tax planning involving related minors. Perhaps even more dramatic was the impact of the 2018 expansion of this tax to include related adults. Because of this impact, the related legislation needed to be very complex in order to prevent the creation of various arrangements which would avoid this extremely onerous tax.

11-111. Unfortunately, the complexity of the legislation was accompanied by an unusual lack of clarity in the meaning of some of its provisions. This has resulted in a situation where dealing with the TOSI has become one of the more difficult areas of tax practice.

11-112. The goal of the material that follows is to provide students and general practitioners with an overview of this material and its application in relatively simple situations. It does not contain sufficient depth or detail to be used by an individual who has to deal with TOSI issues as part of their tax practice.

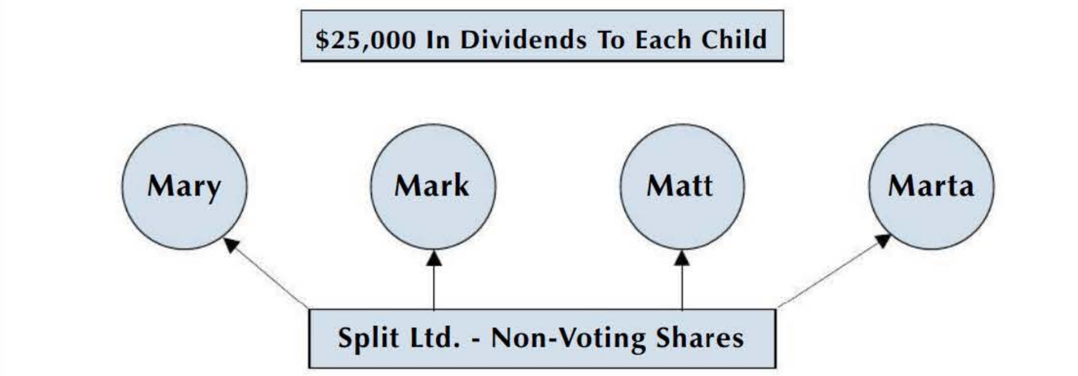
## Background

### *The Problem*

11-113. As discussed in Chapter 1, income splitting is one of the most powerful weapons in the tax planner's arsenal. If an individual with large amounts of income in the top 33 percent federal tax bracket can find a way to channel parts of this income to related parties with either no income or income that leaves them in a lower tax bracket, the tax savings can be significant. Further, in many situations the savings can be repeated year after year.

11-114. As we have seen in earlier chapters, some amount of income splitting is available to all taxpayers without the use of complicated tax structures. The use of spousal RRSPs and the ability to split certain types of pension income are examples of provisions that allow some amount of income splitting. The government appears to be comfortable with these arrangements based on the fact that they are generally available to all Canadian taxpayers that have a spouse or common-law partner.

**Figure 11 - 1**
**Use Of A Corporation To Split Income**




11-115. What did make the government uncomfortable was the ability of a wealthy individual to use more complex tax structures to transfer large amounts of their income to related parties, typically their spouse or their children.

> **EXAMPLE** Melissa Hanson is a very successful individual with annual Net Income For Tax Purposes that regularly places her well into the maximum tax bracket. She owns all of the voting shares in a Canadian controlled private corporation, Split Ltd. Her four children (Mary, Mark, Matt, and Marta) hold all of the Split Ltd. non-voting shares. They had acquired the shares with their own funds.
>
> None of the children have any income of their own, other than dividends received from Split Ltd. During the current year, the corporation pays dividends of $25,000 per year to each child. This situation is illustrated in Figure 11-1.

11-116. Prior to the 2000 introduction of the TOSI, the amount of dividends received by each child could have been received tax free. (The amount of tax free dividends that can be received by an individual with no other source of income is explained in Chapter 15.) In contrast, if she had received the same amount of dividends, Melissa would have been taxed on such dividends at a rate of around 45 percent, depending on the province. This arrangement for allocating Split Ltd. income to her children would provide an annual savings of around $45,000 [($100,000)(45% - Nil)].

## *The Basic TOSI Model*

11-117. While we will define these terms more completely in the material that follows, the TOSI rules are applicable to Split Income. This type of income can occur when Specified Individuals (Melissa's children in our example) receive income from a business that is a Related Business (Split Ltd.) with respect to a Specified Individual because of the involvement of the Source Individual (Melissa) in that business. You should note that there are many exceptions to the applicability of these provisions and when they occur, even in situations such as in our example, the term Split Income is not applicable.

11-118. For amounts of income that are identified as Split Income, the rules are very harsh. Such amounts are subject to the maximum federal tax rate of 33 percent. When this is combined with maximum provincial rates, the result is that such income is taxed at rates as high as 54 percent, the actual rate depending on the province.

11-119. This provision effectively converted such situations as that illustrated in Figure 11-1, from an effective income splitting arrangement, to a situation that results in Melissa paying as much as $9,000 [(54% - 45%)($100,000)] more in federal taxes than would have been the case if the $100,000 in dividends were paid to her, rather than to her children. There

is little question that the TOSI legislation served to significantly reduce the ability of high tax bracket Canadian taxpayers to split income with related persons.

### The 2018 TOSI Changes

11-120. The original version of the TOSI, which became effective in 2000, applied only to related persons who were under the age of 18 at the end of the taxation year, were resident in Canada, and who had a parent who was resident in Canada. Because of this, it was sometimes referred to as the "kiddie tax".

11-121. Further, the definition of Split Income in the 2000 legislation only included dividends from private companies, shareholder benefits on loans received from a private company, or, in some cases, income from a partnership or trust if the income is derived from the provision of property or services to a business.

11-122. There is little question that the 2000 introduction of the TOSI served to curtail income splitting with related minors. However, it was also clear that similar income splitting benefits were being achieved both with other types of income and with related individuals 18 years of age and over. Of particular concern was the use by a parent of various income splitting arrangements to finance the post-secondary education for their children. This specific concern is reflected in the 2018 TOSI legislation which singles out individuals in the 18 to 24 age group for less favourable treatment than is afforded to older related persons.

11-123. Reflecting these concerns, the TOSI legislation that became effective in 2018 expands coverage of this tax in two ways:

> **Types Of Income** As noted, the original TOSI legislation generally limited its coverage to private company dividends, shareholder benefits, and some types of partnership and trust income. Under the current legislation, its coverage has been expanded to include interest received on debt issued by a private corporation, as well as some capital gains on the disposition of private company shares.
>
> **Types Of Individuals** The applicability of the TOSI has been expanded to include all Canadian residents, without regard to age.

11-124. The current TOSI provisions came into effect on January 1, 2018. Complete coverage of these provisions could occupy an entire Chapter in this text, a result which would not be appropriate in a general text such as this. Our coverage will be limited to fairly basic situations and will not deal with the many complications that are found in the complete legislative provisions. While this will provide both students and professionals with a basic understanding of these provisions, this presentation will not provide a satisfactory reference for individuals dealing with complex, real-world cases.

## Determining Applicability

### Relevant Individuals

11-125. Determining the applicability of the TOSI involves identifying two classifications of individuals. These classifications are defined in ITA 120.4(1) and can be described as follows:

> **A Specified Individual** is an individual who is resident in Canada at the end of the year. A further condition for an individual who has not attained the age of 17 before the start of the year is that they must have a parent resident in Canada at any time during the year.
>
> While any Canadian resident could be a Specified Individual, in applying the TOSI, such individuals will generally be a low income individual related to a Source Individual in a high tax bracket.
>
> **A Source Individual** is any individual who, at any time during the year, is related to the Specified Individual.
>
> In applying the TOSI, Source Individuals will generally be high tax bracket individuals who are attempting to split income with related low tax bracket individuals.

11-126. You will notice the extreme breadth of these definitions. Every Canadian resident is a potential Specified Individual. In turn, this means that any person related to that individual could be a Source Individual. Most typical situations would involve a Source Individual operating a private company, with his spouse and/or children being identified as Specified Individuals. However, there are a great many potential relationships that could be viewed as a Specified Individual who is related to a Source Individual.

### Related Business

11-127. In somewhat simplified terms, a business is related to a Specified Individual if the income received by that individual is from a business where:

- in the case of a proprietorship, partnership, or corporation, a Source Individual with respect to the Specified Individual is actively and regularly engaged in the business; or
- a Source Individual with respect to that Specified Individual has an ownership interest. In the case of a corporation, this definition would apply when the Source Individual owns 10 percent or more of the fair market value of all issued and outstanding shares of the corporation. For a partnership, any ownership interest would meet this criterion.

11-128. This is, in fact, a very confusing concept. For purposes of the TOSI, the term Related Business refers to a relationship between the business and the Specified Individual that results from the ownership of, or the involvement in that business by, the Source Individual. This is confusing terminology in that, in many cases, the business and the Source Individual would also be considered related because of other provisions in the *Income Tax Act* (e.g., under ITA 215(2)(b), a corporation is related to a person who controls it). This is not the meaning of "related" that is relevant under the TOSI legislation.

11-129. As an additional point here, we would note that, while the share ownership criteria is easy to apply, the concept of "actively engaged in the business" is not clearly defined and likely to be the source of disputes with taxpayers.

### Split Income

11-130. The actual ITA 120.4(1) definition of Split Income is lengthy and complex. However, for purposes of our coverage, the following items may be classified as Split Income if they are received by a Specified Individual, either directly or indirectly:

- Dividends from a private company that is a Related Business.
- Shareholder benefits or loans from a Related Business.
- Interest from a Related Business.
- Distributions from a proprietorship, or partnership if they are a Related Business.
- Capital gains on the disposition of private company shares if it is a Related Business.
- Distributions from trusts where the source of the income is a Related Business.

11-131. You should note that employment income is not on this list. Employment income is specifically excluded from Split Income, even in situations where it is received from a Related Business.

## Excluded Amounts

### General Approach

11-132. The items listed in Paragraph 11-130 are potential Split Income amounts. However, there are a number of Excluded Amounts and if the item is eligible for one of these exclusions, it is not considered Split Income and will not be subject to the TOSI. Only items that remain after Excluded Amounts are identified will be subject to this tax.

11-133. As with the other amounts we have described, Excluded Amounts are defined under ITA 120.4(1). The analysis of the various Excluded Amounts is complicated by the fact that some of the defined amounts are only available to individuals in certain age groups. Based on this, we have organized our description of the various Excluded Amounts by age group. Note, however, the available amounts overlap these age groups (e.g., an Excluded Amount that is available to individuals over 18 is also available to the 18 to 24 age group).

### Excluded Amounts Available To Individuals Under 25

11-134. The only Excluded Amount that is available to all individuals under 25 is income or taxable capital gains from a property that is acquired as the result of:

- the death of a parent; or
- the death of any person, provided the individual is either:
    - enrolled as a full-time student at a post-secondary educational institution; or
    - eligible for the disability tax credit.

### Excluded Amounts For Individuals Age 18 And Over

11-135. One of the most important of the Excluded Amounts involves the concept of an Excluded Business. This concept can be described as follows:

> **EXCLUDED BUSINESS (Taxpayers Age 18 And Over)** Amounts received from an Excluded Business are not considered Split Income and are not subject to the TOSI. An Excluded Business is one in which the taxpayer is actively engaged on a regular, continuous and substantial basis. This active engagement must be in the current taxation year or in at least 5 prior taxation years. Note, however, the years do not have to be current or consecutive. That is, any 5 years of active engagement will satisfy this condition.
>
> To simplify the application of this rule, the CRA guidance on the TOSI has provided what is referred to as a "bright line" test. This test requires that the taxpayer work in the business an average of at least 20 hours per week during the time the business is in operation. Note that, if the business is seasonal (e.g., a landscaping business), the 20 hours per week requirement is only required for the portion of the year during which the business operates.
>
> The CRA materials also note that a failure to meet this bright line test does not necessarily prevent the taxpayer from using the Excluded Business exception. Whether or not an individual is actively engaged will depend on the facts and circumstances in individual cases.

### Excluded Amounts For Individuals Age 25 And Over

11-136. There are two types of Excluded Amounts that are generally available to taxpayers age 25 and over. The first, Excluded Shares, can be described as follows:

> **EXCLUDED SHARES** Amounts received from Excluded Shares are not considered Split Income and are not subject to the TOSI. For shares to be classified as Excluded Shares, the taxpayer must own, in terms of both fair market value and voting rights, at least 10 percent of the outstanding shares of the corporation. In addition, the corporation must meet the following conditions:
>
> - It must not be a professional corporation. ITA 248(1) defines a professional corporation as a corporation that carries on the professional practice of an accountant, dentist, lawyer, medical doctor, veterinarian, or chiropractor. Corporations carrying on the practice of other professionals, for example architects, do not fall within this definition.
> - Less than 90 percent of its income in the previous year is from the provision of services.

- Less than 10 percent of its income in the previous year was from a related business.

11-137. The second type of Excluded Amount can be described as follows:

**REASONABLENESS TEST** If the income received by the individual represents a reasonable return, taking into consideration labour contributions, the assumption of business risk, as well as capital contributions, it will not be Split Income and will not be subject to the TOSI.

## Excluded Amounts For Individuals Age 18 to 24

11-138. The TOSI legislation indicates two Excluded Amounts for this group of individuals.

**SAFE HARBOUR CAPITAL RETURN** For the income of these individuals to be excluded from the TOSI, it must represent a Safe Harbour Capital Return. This is based on the lowest prescribed rate applied to the capital contributions made by the individual.

**REASONABLENESS TEST (Taxpayers Age 18 To 24)** This second Reasonableness Test is based on a return on contributed capital only, with no consideration of other contributions made to the business by the Specified Individual. This is a much more restrictive test that the one that is available to individuals age 25 and over.

11-139. It is unlikely that this reasonableness test will be widely available to Specified Individuals. It would be unusual for an individual in this age bracket to have been able to accumulate a large amount of capital to contribute to a business. However, when this does occur, it prevents income from the business being classified as Split Income.

## Excluded Amounts Available To Individuals Of Any Age

11-140. The following amounts are Excluded Amounts for an individual of any age, including under 18:

**Capital Gains On Qualified Property** Split Income does not include capital gains on qualified property that is eligible for the lifetime capital gains deduction. This is true, even if the lifetime capital gains deduction is not claimed.

**Property Acquired Through Marriage Breakdown** Split Income does not include amounts that a Specified Individual receives from a property that is acquired as a result of a marriage breakdown agreement. This only applies to property received under a written agreement. Further, it does not apply to property that the Specified Individual owned prior to the marriage breakdown.

**Property Acquired As The Result Of The Death Of A Parent Or Other Individual** Split Income does not include income resulting from property received as the result of the death of a parent or other individual.

**Spouse Is 65 Or Older** For a number of years, legislation has allowed spouses and common-law partners to split pension income (see coverage in Chapter 9). An additional exception has been added to the TOSI legislation to allow a similar result for amounts that might be considered Split Income.

Specifically, Split Income does not include income received by a spouse of any age, if that income would not have been Split Income if it had been received by their spouse who is 65 years of age or older.

11-141. In many cases, the process of determining whether there are Excluded Amounts will be very complex. When this is combined with the procedures needed to identify related Source Individuals and potential Split Income amounts, most individuals who use their businesses to Split Income will require professional advice.

11-142. That being said, the importance of making good decisions in this area is crucial. As will be demonstrated in the next section, the TOSI is a very costly tax. It can turn what was intended to be a source of tax reduction through income splitting into a situation that actually has a tax cost to the taxpayer.

## Calculation Of The Tax

### *The Tax Credit Problem*

11-143. When a Specified Individual has received Split Income, their Tax Payable is made up of two components. The first component is based on a calculation that, under ITA 20(1)(ww), removes the Specified Individual's Split Income from the total. This can create a problem in determining tax credits that are income tested.

> **EXAMPLE** Josh Browning has taxable income of $250,000, while his spouse Maria has Taxable Income of $15,000, all of which is Split Income. When the deduction is made under ITA 20(1)(ww), the remaining balance of Maria's Income will be nil.
>
> **ANALYSIS** The problem with this result is that if the nil amount was used for calculating income tested tax credits, the subtraction of the Split Income would result in the creation of a spousal tax credit for Josh of $1,810 [(15%)($12,069 - nil)]. In contrast, if there had been no Split Income subtraction, Maria's income would exceed the 2019 base for the spousal tax credit of $12,069, resulting in no spousal tax credit for Josh.
>
> The government did not believe that this was an appropriate result and added ITA 118(4)(a.2). This provision indicates that for purposes of determining personal tax credits, the Net Income figure that would be used would be before the ITA 20(1)(ww) deduction. This means that Josh's spousal tax credit would be nil ($12,069 - $15,000).

### *Two Components*

11-144. With the ITA 20(1)(ww) subtraction, the taxpayer's income is made up of two components:

> **Split Income Component** This component will be subject to a federal flat rate of 33 percent. The only credits against the resulting Tax Payable will be dividend tax credits, foreign tax credits that relate to the amounts included in Split Income, and the disability tax credit.
>
> **Regular Income Component** This component will be subject to the regular graduated rates and will be eligible for the usual tax credits, subject to the ITA 118(4)(a.2) provision (see ANALYSIS in Paragraph 11-143).

11-145. A simple example will serve to illustrate these calculations.

> **EXAMPLE** Helen, who is 25 years old, receives non-eligible dividends of $20,000 from a private company controlled by her father. In addition, she has interest income of $5,500 from a savings account funded by an inheritance. Her only tax credits are the basic personal credit and the dividend tax credit. She is not eligible for any exclusion from the application of the TOSI.
>
> **ANALYSIS** The initial calculation involves determining the tax on total income, reduced by amounts that fall within the definition of Split Income (the non-eligible dividends). All of the usual tax credits can be claimed in this calculation.

| | |
|---|---|
| Taxable Non-Eligible Dividends [(115%)($20,000)] | $23,000 |
| Interest Income | 5,500 |
| Deduction For Split Income - Non-Eligible Dividends | ( 23,000) |
| Net Income For Tax Purposes = Taxable Income | $ 5,500 |
| Tax Rate | 15% |
| Tax Payable Before Credits | $ 825 |
| Basic Personal Credit [(15%)($12,069)] | ( 1,810) |
| Federal Tax Payable On Regular Income | Nil |

The TOSI Payable would be calculated as follows:

| | |
|---|---|
| Split Income - Taxable Non-Eligible Dividends | $23,000 |
| Tax Rate | 33% |
| Tax Payable Before Dividend Tax Credit | $ 7,590 |
| Dividend Tax Credit [(9/13)(15%)($20,000)] | ( 2,077) |
| TOSI Payable | $ 5,513 |

With the regular component being nil, the total Tax Payable will be $5,513, the amount based on the Split Income sources.

11-146. In some circumstances, Source Individuals may be liable for payment of the TOSI if the Specified Individual fails to make the required payment.

### *Evaluation*

11-147. Both the original Kiddie Tax legislation, as well as the expansion of the TOSI coverage to adult taxpayers, were met with howls of protest from many in the tax community. In our view, these changes represented appropriate modifications. The type of income splitting that is being attacked in these provisions is, in general, only available to higher income Canadians. It would be difficult to describe our tax system as fair if such arrangements were allowed to continue.

**Exercise Eleven - 10**

**Subject:** Tax On Split Income

During 2019, Norton James, who is 16 years old, receives non-eligible dividends of $15,000 from a private corporation controlled by his mother. He also has income of $13,200 from contracts to create computer games. As he has used the income that he has earned from these contracts in previous years to invest in the stock market, he has eligible dividends from publicly traded companies of $8,600. Assume his only tax credits are his basic personal credit and dividend tax credits on the shares that he owns. Determine Norton's federal Tax Payable for 2019.

**SOLUTION available in print and online Study Guide.**

**We suggest you work Self Study Problem Eleven-4 at this point.**

# Tax Credits Revisited

## Transfer Of Dividends To A Spouse Or Common-Law Partner

11-148. There may be situations in which a taxpayer's spousal credit has been reduced or eliminated by dividends received by that spouse. The ITA 82(3) election permits a transfer of all of the dividends from the spouse or common-law partner's income to that of the taxpayer, if

it creates or increases the spousal credit. Consider the following example:

**EXAMPLE** Mrs. Barba's total income consisted of $12,000 in eligible dividends received from taxable Canadian corporations. Mrs. Barba's basic personal tax credit, along with part of the dividend tax credit, eliminate all taxation on the grossed up amount of $16,560 [(138%)($12,000)]. However, because she has this income receipt, Mr. Barba is not able to claim a spousal tax credit.

**ANALYSIS** In this situation, the transfer of dividends under ITA 82(3) would eliminate all of Mrs. Barba's income, and Mr. Barba would be able to claim the full spousal credit of $1,810. Mr. Barba would then be taxed on the $16,560 of grossed up dividends. He would, however, be eligible for the dividend tax credit associated with these dividends. Whether this is a good alternative or not depends on Mr. Barba's marginal tax rate, as can be seen in the following calculations:

| Mr. Barba's Tax Bracket | 15% | 33% |
|---|---|---|
| Increase In Taxable Income | $16,560 | $16,560 |
| Tax On $16,560 | $ 2,484 | $ 5,465 |
| Increase In Spousal Credit | ( 1,810) | ( 1,810) |
| Dividend Tax Credit [(6/11)(38%)($12,000)] | ( 2,487) | ( 2,487) |
| Increase (Decrease) In Tax Payable | ($ 1,813) | $ 1,168 |

As can be seen in the table, if Mr. Barba is in the 15 percent tax bracket, his federal tax would be decreased by $1,813. Alternatively, if he is in the 33 percent bracket, the transfer would not be desirable as his federal tax would be increased by $1,168.

## Exercise Eleven - 11

**Subject:** Transfer Of Dividends To A Spouse

Mr. Albert Ho is 38 years old and has over $250,000 in 2019 Taxable Income. His wife's only 2019 source of income is $8,500 in eligible dividends received from taxable Canadian corporations. In terms of federal Tax Payable, would Mr. Ho benefit from the use of the ITA 82(3) election to include the eligible dividends received by his spouse in his Net Income For Tax Purposes? Justify your conclusion.

**SOLUTION available in print and online Study Guide.**

**We suggest you work Self Study Problems Eleven-5 and 6 at this point.**

## Charitable Donations Credit Revisited

### *Introduction*

11-149. A basic treatment of this credit was provided in Chapter 4. In that Chapter, we noted that, for individuals, the first $200 of donations was eligible for a tax credit of 15 percent. The rate applicable to additional amounts was either 29 percent or 33 percent depending on the Taxable Income of the donor. In general, the base for calculating this credit was limited to 75 percent of the taxpayer's Net Income For Tax Purposes.

11-150. In Chapter 4, we dealt only with simple situations involving gifts of cash. Coverage of more complex issues involving gifts of various types of capital property was deferred and is included in this Chapter 11.

11-151. As many of you are aware, in recent years, a number of gift giving programs have been developed that appear to provide the taxpayer with benefits that exceed his cost and, in some cases, the value of the gift to the recipient charity.

11-152. A classic example of this was the so-called art flips. Such arrangements might involve a taxpayer buying a large block of paintings directly from the inventories of the artist. The cost of the block was essentially a wholesale value and was significantly lower than the sum of the retail prices of the individual paintings. The paintings would then be appraised on the basis of individual retail values, followed by a gift of the art works to a registered charity. The taxpayer would then claim a tax credit based on the significantly higher appraised value, often resulting in a tax credit that was worth more than the original cost of the paintings.

11-153. Because of problems such as this, ITA 248(30) through ITA 248(41) were added to the *Income Tax Act*. These subsections are intended to curtail the ability of taxpayers to use schemes which abuse the intent of the basic charitable donations legislation.

### Donations Classified

11-154. ITA 118.1 defines four types of charitable donations:

1. **Total Charitable Gifts** is defined to include all eligible amounts donated by an individual to a registered charity, a registered Canadian amateur athletic association, a Canadian municipality, the United Nations or an agency thereof, a university outside of Canada which normally enrolls Canadian students, and a charitable organization outside of Canada to which Her Majesty in right of Canada has made a gift in the year or in the immediately preceding year.
2. **Total Crown Gifts** is defined as the aggregate of eligible amounts donated to Her Majesty in right of Canada or a province.
3. **Total Cultural Gifts** is defined as the aggregate of all eligible gifts of objects that the Canadian Cultural Property Export Review Board has determined meet the criteria of the *Cultural Property And Import Act*.
4. **Total Ecological Gifts** is defined as all eligible gifts of land certified by the Minister of the Environment to be ecologically sensitive land, the conservation and protection of which is important to the preservation of Canada's environmental heritage. The beneficiary of the gift can be any level of government. The beneficiary can also be a registered charity, provided its primary purpose is the conservation and protection of Canada's environmental heritage.

11-155. In addition to the items specified in the *Act*, under the U.S./Canada tax treaty, Canadians can claim gifts to any qualifying U.S. charity in amounts up to 75 percent of their net U.S. income (75 percent of their net world income if the Canadian resident lives near the U.S. border and commutes to a U.S. place of business or employment).

### Eligible Amounts

11-156. In the preceding material on the classification of donations, each of the definitions contains the term "eligible amounts". The term is defined as follows:

> **ITA 248(31)** The eligible amount of a gift or monetary contribution is the amount by which the fair market value of the property that is the subject of the gift or monetary contribution exceeds the amount of the advantage, if any, in respect of the gift or monetary contribution.

11-157. ITA 248(32) defines "advantage" very broadly to include a benefit to the taxpayer that is in any way related to the gift, including benefits that are contingent on future events.

> **EXAMPLE** As an example of an advantage, consider a gift of real property with a fair market value of $300,000. If the charity receiving the gift were to assume a $100,000 mortgage on the property, this would be considered an advantage. The resulting eligible amount of the donation is $200,000 ($300,000 - $100,000).

11-158. In addition to this eligibility requirement, ITA 248(30) includes the concept of "intention to give". The basic idea here is that, if the advantage to the taxpayer resulting from making the gift exceeds 80 percent of the value of the gift, the gift will be disallowed unless the

taxpayer can convince the Minister that the transfer was made with a real intention to make a gift.

### Deemed Fair Market Value

11-159. In order to eliminate arrangements such as the art flip that was described in Paragraph 11-152, ITA 248(35) introduces the concept of "deemed fair market value". This Subsection indicates that, if a taxpayer acquires a property less than three years prior to its donation as a gift or, if a taxpayer acquires a property less than 10 years before the gift is made and it is reasonable to conclude that the taxpayer acquired the property with an intent to make a gift, the value of the gift will be based on the lesser of the cost to the taxpayer and the actual fair market value at the time of the gift. There is an exception to this rule for gifts made as a consequence of a taxpayer's death.

### Gifts Of Capital Property - Transfer At Elected Value

11-160. When an individual makes a charitable, Crown, or ecological (but not cultural) gift of capital property, an election is available under ITA 118.1(6). On such properties, there will usually be a difference between the tax cost of the property (i.e., adjusted cost base for non-depreciable properties or UCC for depreciable properties) and its fair market value. If the fair market value is the higher value, the taxpayer can elect to transfer the property at any value between the tax cost of the property and its fair market value. There are special rules applicable to gifts of publicly traded securities and ecologically sensitive land that will be covered in Paragraph 11-167.

11-161. With respect to non-depreciable assets, if the fair market value of the donated asset exceeds the adjusted cost base of the asset, it is advisable to elect the fair market value. Any amount of elected value in excess of $200 will be eligible for a tax credit at either 29 percent or 33 percent. In contrast, only one-half of any capital gain that results from the disposition will be taxed.

> **EXAMPLE** Mr. Vignesh Menan has a piece of land with an adjusted cost base of $100,000 and a fair market value of $150,000. During 2019, he intends to gift this land to a registered Canadian charity and would like to know whether he should elect to make the donation at $100,000 or alternatively, at $150,000. Before consideration of any income resulting from making the gift, Mr. Menan has Taxable Income of more than $400,000. Given this, any amount of donations in excess of $200 will receive a credit based on the maximum tax rate of 33 percent.
>
> **ANALYSIS** The tax consequences of the two alternatives are as follows:

| **Elected Value** | **$100,000** | **$150,000** |
|---|---|---|
| Tax Credit [(15%)($200) + (33%)($99,800)] | $ 32,964 | |
| Tax Credit [(15%)($200) + (33%)($149,800)] | | $ 49,464 |
| Tax On Gain | N/A | |
| Tax On Gain [(1/2)($150,000 - $100,000)(33%)] | | ( 8,250) |
| Credit Net Of Tax | $ 32,964 | $ 41,214 |

11-162. It should be noted that ITA 118.1(6) places a floor on this election. The elected value cannot be below the amount of any advantage received by the taxpayer as a consequence of the gift.

> **EXAMPLE - Extended** Mr. Vignesh Menan has a piece of land with an adjusted cost base of $100,000 and a fair market value of $150,000. In return for making this gift, he receives a cash payment from the registered charity of $110,000.
>
> **ANALYSIS** Mr. Menan cannot elect a value below $110,000. Assuming he elects to transfer the asset at the maximum value of $150,000, the eligible amount of his gift will be $40,000 ($150,000 - $110,000).

11-163. The situation is not so clear when depreciable assets are involved. This results from the fact that an election at fair market value may create fully taxable recapture. The taxes on such recapture may be a bit more than the credit generated by the donation as the credit on the first $200 is at 15 percent.

### Gifts Of Capital Property - Income Limits

11-164. In most cases, an individual's eligible donations are restricted to 75 percent of Net Income For Tax Purposes for the year (see Chapter 4). A potential problem with electing a value that creates income is that making a gift and electing to use the fair market value may result in income that cannot be eliminated with the related tax credit. In other words, making a gift could result in the payment of taxes. To avoid this problem, two other components are added to the Net Income base for charitable donations, resulting in a total base equal to:

- 75 percent of Net Income For Tax Purposes for the year; plus
- 25 percent of any taxable capital gain resulting from a gift; plus
- 25 percent of any recaptured CCA resulting from a gift.

11-165. An example will illustrate the importance of these additions to the overall limit:

**EXAMPLE** In July, 2019, Jonas Anderson gifts a customized bus that was used in his proprietorship to a registered Canadian charity. The bus has a fair market value of $130,000, a capital cost of $100,000, and a UCC of $65,000. He elects to make the gift at the fair market value of $130,000. He has no other source of income, other than amounts arising as a result of the gift.

**ANALYSIS** The election to make the gift at the fair market value of $130,000 will result in a total increase in Net Income For Tax Purposes of $50,000. This is comprised of a taxable capital gain of $15,000 [(1/2)($130,000 - $100,000)] and recaptured CCA of $35,000 ($100,000 - $65,000).

As Mr. Anderson has no other source of income, his basic limit for charitable donations would be $37,500 [(75%)($50,000)]. If his limit was $37,500, he would be faced with paying tax on $12,500 ($50,000 - $37,500) less his personal tax credits, as a result of his generosity in making the gift. However, with the additions to the limit, his charitable donations credit base limit is as follows:

| | |
|---|---:|
| 75 Percent Of Net Income For Tax Purposes [(75%)($50,000)] | $37,500 |
| 25 Percent Of Taxable Capital Gain [(25%)($15,000)] | 3,750 |
| 25 Percent Of Recaptured CCA [(25%)($35,000)] | 8,750 |
| Total Limit (Equals Income From Donation) | $50,000 |

11-166. As you can see, the additions to the limit serve the purpose of creating a base for charitable donations that includes 100 percent of any income resulting from gifts of capital property. Note, however, Mr. Anderson will not want to use the full $50,000 in 2019. As amounts over $200 will generate a credit at a rate of 29 percent (the 33 percent rate is not relevant as Mr. Anderson's Taxable Income is well below the $210,371 threshold for that rate) and all of Mr. Anderson's income will be taxed at a lower rate, use of the full $50,000 would produce a credit that is larger than his Tax Payable. In addition, he will want to make use of any non-refundable tax credits that are available for 2019. The following Exercise illustrates the determination of the amount of an available tax credit that should be taken in order to reduce Tax Payable to nil.

## Exercise Eleven - 12

**Subject:** Donation Of Depreciable Property

Ms. Sally Felder donates some food preparation equipment to the local food bank, a registered Canadian charity. The assets have a fair market value of $85,000, a capital cost of $62,000, and a UCC of $28,000. She elects to make the donation at the fair market value of $85,000. She has no other source of income during the year and her only tax credit other than the charitable donations tax credit is her basic personal credit of $1,810.

Determine her maximum charitable donations tax credit for 2019. In addition, determine the amount of the donation she should claim in 2019 in order to reduce her federal Tax Payable to nil. Calculate any carry forward of unused amounts that will be available in future years.

**SOLUTION available in print and online Study Guide.**

### *Gifts Of Publicly Traded Securities And Ecologically Sensitive Land*

11-167. Gifts of publicly traded securities and ecologically sensitive land benefit from special rules that make gifting these assets particularly attractive. While a donor can receive a donations tax credit based on the full fair market value of such assets, ITA 38(a.1) deems the capital gain on gifts of publicly traded securities to be zero. Using the same approach, ITA 38(a.2) deems the capital gain on gifts of ecologically sensitive land to be zero.

## Exercise Eleven - 13

**Subject:** Donation Of Listed Shares

Mr. Saheed Radeem has employment income of $90,000. He owns shares that are listed on the Toronto Stock Exchange. These shares have a fair market value of $110,000 and an adjusted cost base of $30,000. During 2019, these shares are given to a registered Canadian charity. He has no deductions in the calculation of Taxable Income (i.e., his Taxable Income is equal to his Net Income For Tax Purposes). His tax credits, other than the charitable donations credit, total $4,000.

Determine Mr. Radeem's maximum charitable donations tax credit for 2019 and the amount of the donation he should claim in 2019 in order to reduce his federal Tax Payable to nil. Calculate any carry forward of unused amounts that will be available in future years.

**SOLUTION available in print and online Study Guide.**

### *Gifts Of Publicly Traded Securities Acquired Through Stock Options*

11-168. Without special rules, there is a potential problem for donations of publicly traded shares purchased through stock options. You will recall from Chapter 3 that, in the case of these shares, any accrued gain that is present at the time the options are exercised is treated as an employment income inclusion. In order to give such gains effective capital gains treatment, a deduction of one-half is provided in the determination of Taxable Income.

**EXAMPLE** Roberto Cerutti is provided with options to buy 1,000 of his employer's shares at an option price of $20 per share, the fair market value of the shares at the time the options are granted. Roberto exercises these options when the shares are trading at $32 per share. He gifts the shares immediately to a registered charity.

**ANALYSIS** Roberto will have an increase in Taxable Income calculated as follows:

| | |
|---|---:|
| Employment Income [(1,000)($32 - $20)] | $12,000 |
| Deduction Under ITA 110(1)(d) [(1/2)($12,000)] | ( 6,000) |
| Increase In Taxable Income | $ 6,000 |

11-169. As this increase in Taxable Income is not a capital gain, it will not be deemed to be zero by ITA 38(a.1). In the absence of a further special provision, this $6,000 would be subject to tax. Fortunately, ITA 110(1)(d.01) contains a provision which acts to eliminate this tax. This paragraph provides an additional deduction equal to one-half of the Employment Income inclusion. Using this additional provision, the results would be as follows:

| | |
|---|---:|
| Employment Income [(1,000)($32 - $20)] | $12,000 |
| Deduction Under ITA 110(1)(d) [(1/2)($12,000)] | ( 6,000) |
| Deduction Under ITA 110(1)(d.01) [(1/2)($12,000)] | ( 6,000) |
| Increase In Taxable Income | Nil |

### Canadian Cultural Property

11-170. We have noted that, when an individual makes a charitable, Crown or ecological gift of capital property, they can elect to have the proceeds of disposition be any value between the tax cost of the property and the fair market value. In the case of cultural gifts of capital property, ITA 118.1(10.1) deems the proceeds of disposition to be the fair market value of the property in all cases. Note, however, that this same Subsection indicates that the value established by the Canadian Cultural Property Export Review Board or the Minister of the Environment is deemed to be the fair market value of the donated asset.

11-171. This fair market value rule must be considered in conjunction with the fact that a provision in ITA 39(1)(a)(i.1) indicates that, with respect to gifts of Canadian cultural property, the difference between the fair market value and the adjusted cost base of the asset does not fall within the meaning of capital gain. As a consequence, any gain on a gift of Canadian cultural property is not subject to tax. Losses, however, would be treated as normal capital losses. Given this, it is not unreasonable to require that the proceeds of disposition on cultural gifts of capital property be equal to the fair market value of the property.

### Limits On Amount Claimed And Carry Forward Provisions

11-172. As noted in Chapter 4, it is the policy of the government to limit charitable donations that are eligible for the tax credit to a portion of a taxpayer's Net Income For Tax Purposes. Note that, while corporations deduct their donations as opposed to receiving a credit against Tax Payable, the limits on the amount of eligible donations are the same for corporations as they are for individuals.

11-173. The limit on eligible amounts of charitable gifts is 75 percent of Net Income For Tax Purposes, but there are exceptions to this general limit. For individuals, this limit is increased to 100 percent of Net Income For Tax Purposes in the year of death and the preceding year. In those situations where a gift of capital property resulted in a capital gain and/or recaptured CCA, the overall limit is increased by 25 percent of the taxable capital gain and 25 percent of any recaptured CCA resulting from such a gift. There is no income limit on the amount of Crown gifts, cultural gifts, or ecological gifts. Credits can be claimed for these gifts up to their full eligible amounts.

11-174. The *Income Tax Act* does not require that charitable donations be claimed in the year that they are made. Unused charitable donations can be carried forward and claimed in the subsequent 5 year period (10 years for ecological gifts). In the carry forward period, the same income based limits will apply in determining eligible amounts.

# Foreign Tax Credits Revisited

## Rules For Corporations

11-175. Corporations are allowed to use foreign non-business income and foreign business income tax paid as a basis for a credit against Canadian Tax Payable. The rules for corporations are somewhat different from those for individuals and, in addition, require an understanding of some concepts that have not been introduced at this stage in the material. As a result, the foreign tax credit rules applicable to corporations are discussed in Chapter 12.

## Foreign Non-Business (Property) Income Tax Credit For Individuals

11-176. ITA 126(1) provides for a tax credit in situations where a Canadian resident has paid foreign taxes on non-business income. We introduced coverage of foreign tax credits in Chapter 7, but could not fully discuss the calculations as we had not yet covered loss carry overs and the lifetime capital gains deduction.

11-177. As was noted in Chapter 7, the full amount of foreign non-business income earned, including amounts withheld for taxes in the foreign jurisdiction, must be added to the taxpayer's Net Income For Tax Purposes. This 100 percent amount is then subject to Canadian taxes, with the amount withheld in the foreign jurisdiction being allowed as a credit against Canadian Tax Payable. The objective of this procedure is to tax non-business income earned in a foreign jurisdiction at the same overall rate as would apply to non-business income earned in Canada.

11-178. There are a number of complications with this procedure. The first of these is that, for individuals, amounts withheld that exceed 15 percent of the total foreign non-business income must be deducted under ITA 20(11). If, for example, an individual earned $1,000 in a jurisdiction that withheld $200, $150 of this amount would serve as a credit against Tax Payable, with the remaining $50 being deducted under ITA 20(11).

11-179. A further problem is that the federal government wants to ensure that taxpayers do not receive a credit that is greater than the Canadian taxes that would have been paid on the foreign non-business income. This is accomplished by limiting the foreign non-business tax credit to the lesser of the amount withheld, and the amount determined by multiplying the ratio of foreign non-business income to total income by Canadian Tax Payable. This approach is reflected in the following formula:

The **Foreign Non-Business Income Tax Credit** is the lesser of:

- The tax paid to the foreign government. For individuals, this is limited to 15 percent of foreign non-business income, and
- An amount determined by the following formula:

$$\left[\frac{\text{Foreign Non}-\text{Business Income}}{\text{Adjusted Division B Income}}\right][\text{Tax Otherwise Payable}]$$

11-180. The "Adjusted Division B Income" in this formula is defined as follows:

Division B Income (i.e., Net Income For Tax Purposes), less:
- net capital loss carry overs deducted under ITA 111(1)(b);
- any lifetime capital gains deduction taken;
- any amounts deductible for stock options under ITA 110(1)(d) and (d.1); and
- any amounts deductible under ITA 110(1)(f) for workers' compensation, social assistance or exempt foreign income.

11-181. "Tax Otherwise Payable" in this calculation consists of:

Part I Tax Payable before the deduction of:
- dividend tax credits;
- employment outside of Canada tax credits;
- political contributions tax credits;
- investment tax credits; and
- labour sponsored funds tax credits.

11-182. You should note that the preceding definition of Adjusted Division B Income is unique to the calculation of foreign tax credits. It starts with Net Income For Tax Purposes (Division B Income), and proceeds to deduct some, but not all, of an individual's available Division C deductions. The most important omission is the fact that non-capital losses are not deducted. As a result, "Adjusted Division B Income" is a figure that is neither Net Income For Tax Purposes nor Taxable Income.

11-183. The preceding rules would have to be applied on a country by country basis if non-business income was received from more than one foreign source. If the amount of foreign non-business taxes withheld exceeds the amount determined by the formula, there is no carry over of the unused amount as a tax credit. However, ITA 20(12) allows a taxpayer to deduct such amounts in the determination of Net Income For Tax Purposes.

### *Foreign Business Income Tax Credit For Individuals*

11-184. If a Canadian resident has income from an unincorporated business in a foreign country, ITA 126(2) provides for a credit for foreign taxes paid that is similar to that for non-business income. As is the case with foreign non-business income tax credits, individuals must include 100 percent of the foreign business income in their Net Income For Tax Purposes, with foreign taxes withheld being allowed as a credit against Tax Payable.

11-185. While the amount of the credit that can be used does not have the 15 percent limit that is applicable to foreign non-business income tax credits, it is limited by a formula that is similar to the formula applicable to the foreign non-business income tax credit. One of the main differences between these two formulas is that, with respect to the foreign business income tax credit, there is an additional limit based on the tax otherwise payable for the year, reduced by any foreign non-business income tax credit deducted. The calculation of the foreign business income tax credit is as follows:

The **Foreign Business Income Tax Credit** is the least of:

- The tax paid to the foreign government (no 15 percent limit).
- An amount determined by the following formula:

$$\left[\frac{\text{Foreign Business Income}}{\text{Adjusted Division B Income}}\right][\text{Tax Otherwise Payable}]$$

- Tax Otherwise Payable for the year, less any foreign tax credit taken on non-business income under ITA 126(1).

11-186. A further important difference between the two foreign tax credits is that, when foreign business income taxes paid exceed the amount that can be used as a credit during the current year, there is a 3 year carry back and 10 year carry forward available. That is, if a taxpayer does not have sufficient Tax Payable to use all of the foreign business income tax credit during the current year, the excess can be claimed against Tax Payable in any of the 3 preceding years, or in any of the 10 subsequent years. Note, however, that it can only be used in those years within the constraints provided by the formula in Paragraph 11-186.

## Exercise Eleven - 14

**Subject:** Foreign Tax Credits

During 2019, Sarah Cheung has net rental income of $44,000, net taxable capital gains of $2,500 and foreign non-business income of $3,500. The foreign jurisdiction withheld 11 percent of this amount, resulting in a net receipt of $3,115. In calculating Taxable Income, she deducts a $4,000 non-capital loss carry forward and a $2,500 net capital loss carry forward. Her only tax credits are the basic personal credit and the credit for foreign tax paid.

Calculate her federal Tax Payable for 2019. Include a detailed calculation of her foreign non-business income tax credit. Ignore the fact that Sarah could deduct any excess of the withholding amount ($385) over the actual credit in the determination of Net Income For Tax Purposes.

**SOLUTION available in print and online Study Guide.**

# Alternative Minimum Tax

## General Concept

11-187. There is a strong public feeling that allowing wealthy individuals with high levels of income to pay little or no tax is not an equitable situation. While such cases usually involve no more than taking full advantage of the various provisions in the *Act* that allow individuals to reduce their Tax Payable, the government felt that it was necessary to have legislation in place to deal with this public relations problem. As a result, an alternative minimum tax (AMT) was introduced.

11-188. This tax is directed at individuals who take advantage of tax shelters and other "tax preference" items. The basic idea is that individuals who have certain types of income, deductions, or credits, must calculate an adjusted taxable income by adding back all of the "tax preferences" that have been used in the calculation of regular taxable income. As will be discussed in Chapter 19, for income tax purposes, trusts are considered to be individuals. Given this, with a few exceptions, trusts are subject to the AMT.

11-189. After deducting a basic $40,000 exemption, a flat rate of 15 percent is applied to the remaining net adjusted taxable income. The resulting Tax Payable is reduced by some, but not all, of the individual's regular tax credits to arrive at a minimum tax. The taxpayer must pay the greater of the regular Tax Payable and the minimum tax. Again, as will be discussed in Chapter 19, the $40,000 exemption is not available to trusts in calculating their minimum tax. The one exception to this is a testamentary trust that has been designated as a graduated rate estate.

## Minimum Tax Calculation

### *Definition*

11-190. The minimum tax is specified in ITA 127.51 as follows:

An individual's minimum amount for a taxation year is the amount determined by the formula

**A (B - C) - D**, where

**A** is the appropriate percentage for the year (15 percent for 2019);
**B** is his adjusted taxable income for the year determined under section 127.52;
**C** is his basic exemption for the year (currently $40,000); and
**D** is his basic minimum tax credit for the year determined under section 127.531.

### *Adjusted Taxable Income*

11-191. The calculation of adjusted taxable income that is described in ITA 127.52 is illustrated in a somewhat more comprehensible fashion in Form T691. The basic idea behind this adjusted taxable income is to put back into regular taxable income those items that are felt to be "tax preferences". Examples of such preference items would be losses on tax shelters and the non-taxable portion of capital gains.

11-192. The calculation of adjusted taxable income described in ITA 127.52 is as follows:

**Regular Taxable Income**

**Plus Additions:**

- 30 percent of the excess of capital gains over capital losses (see Paragraph 11-193).
- 3/5 of the employee stock option deductions under ITA 110(1)(d) and (d.1).
- Amounts of CCA on Certified Canadian Films.
- The excess of CCA and interest charges claimed on rental and leasing property, over the net income or loss reported for such property.
- Amounts deducted for Canadian Exploration Expense (CEE), Canadian Development Expense (CDE), or depletion, net of certain resource related income.
- Losses deducted by limited partners, and members of a partnership who have been specified members at all times since becoming partners, in respect of their partnership interests, net of certain gains allocated from the same partnership.
- Deductions related to investments identified or required to be identified under the tax shelter identification rules.

**Less Deductions:**

- The gross up of Canadian dividends.
- 60 percent of ABILs deducted (see Paragraph 11-194).
- 60 percent of net capital loss carry overs deducted.

**Equals: Adjusted Taxable Income For Minimum Tax Purposes**

11-193. Rather than require that all of the non-taxable component of capital gains be added back, which could result in an excessive number of taxpayers being exposed to alternative minimum tax, only 30 percent of the total capital gain is added in the Adjusted Taxable Income calculation. This brings the total inclusion of the excess of capital gains over capital losses to 80 percent (50 percent is already included in regular income, plus the additional 30 percent).

11-194. The government also decided that this 80 percent treatment was appropriate for ABILs. The Adjusted Taxable Income calculation requires an additional deduction of 60 percent of any ABILs deducted in the year. Since 60 percent of an ABIL is equal to 30 percent of the total Business Investment Loss and 50 percent is already deducted from regular income, this effectively provides for a total deduction equal to 80 percent of the Business Investment Loss.

### *Tax Payable Before Credits*

11-195. A basic exemption of $40,000 is subtracted from the adjusted taxable income figure. As noted, this $40,000 exemption is not available to trusts, other than those testamentary trusts that have been designated as graduated rate estates.

11-196. After subtraction of the basic exemption, a flat rate is applied to the resulting balance. This rate is referred to in the ITA 127.51 formula as the "appropriate percentage". Appropriate percentage is defined in ITA 248 as the lowest percentage applicable in calculating federal Tax Payable. Since 2007, this rate has been 15 percent. The resulting figure could be described as the alternative minimum tax before the deduction of tax credits.

## Tax Credits For AMT

11-197. ITA 127.531 specifies the tax credits, as calculated for the determination of regular Tax Payable, which can be applied against the alternative minimum tax. The credits specified are as follows:

- Personal credits under ITA 118(1)
- Age credit under ITA 118(2), but not the transfer from a spouse
- Canada employment credit under ITA 118(10)

- Adoption expenses credit under ITA 118.01
- Home accessibility credit under ITA 118.041
- First time home buyer's credit under ITA 118.05
- Volunteer firefighters credit under ITA 118.06
- Volunteer search and rescue workers credit under ITA 118.07
- Charitable donations credit under ITA 118.1
- Medical expense credit under ITA 118.2
- Disability credit under ITA 118.3, but not the transfer from a spouse or other dependant
- Tuition credit under ITA 118.5, but not the transfer from a spouse or other dependant
- Interest on student loans credit under 118.62
- CPP and EI credits under ITA 118.7

11-198. The deduction of these credits will produce the alternative minimum tax payable. If this amount exceeds the regular taxes that are payable on the regular taxable income, the amount of alternative tax must be paid.

### AMT Carry Forward - ITA 120.2

11-199. There will be individuals who become subject to this alternative minimum tax in only some taxation years. The most common example of this situation is the realization of a large capital gain that can be eliminated by the use of the lifetime capital gains deduction.

11-200. To provide for this, an excess of alternative minimum tax over regular Tax Payable can be carried forward for up to 7 years to be applied against any future excess of regular Tax Payable over the alternative minimum tax.

**Exercise Eleven - 15**

**Subject:** Alternative Minimum Tax

Mr. Norton Blouson has Taxable Income for 2019 of $85,000. This includes taxable capital gains of $22,500 and taxable eligible dividends of $27,600 [(138%)($20,000)]. In addition, he received a $50,000 retiring allowance that was contributed to his RRSP. The full contribution was deductible. His only tax credits are the basic personal credit and the dividend tax credit. Determine whether Mr. Blouson would have a liability for alternative minimum tax and, if so, the total amount of such tax.

**SOLUTION available in print and online Study Guide.**

## Sample Comprehensive Personal Tax Return

11-201. In the separate paper Study Guide, there is a comprehensive example containing a completed personal tax return, as well as a Tax Software Self Study Problem, included in the material for Chapter 11. The sample return illustrates tax savings possible through pension income splitting.

**We suggest you work Self Study Problems Eleven-7 through Eleven-11.**

**Additional Supplementary Self Study Problems Are Available Online.**

## Key Terms Used In This Chapter

11-202. The following is a list of the key terms used in this Chapter. These terms, and their meanings, are compiled in the Glossary located at the back of the Study Guide.

| | |
|---|---|
| Active Business | Loss Carry Back |
| Active Business Income | Loss Carry Forward |
| Adjusted Taxable Income | Lump-Sum Payments |
| Allowable Business Investment Loss | Net Capital Loss |
| Alternative Minimum Tax (AMT) | Net Income For Tax Purposes |
| Annual Gains Limit | Non-Capital Loss |
| Business Investment Loss | Ordering Rule |
| Carry Over | Personal Use Property |
| Charitable Donations Tax Credit | Purification Of A Small Business Corporation |
| Charitable Gifts | Professional Corporation |
| Crown Gifts | Qualified Farm Property |
| Cultural Gifts | Qualified Fishing Property |
| Cumulative Gains Limit | Qualified Small Business Corporation |
| Cumulative Net Investment Loss | Restricted Farm Loss |
| Ecological Gifts | Small Business Corporation |
| Excluded Business | Source Individual |
| Excluded Shares | Specified Individual |
| Farm Property | Split Income |
| Fishing Property | Stock Option |
| Foreign Taxes Paid Credit | Taxable Income |
| Lifetime Capital Gains Deduction | TOSI |
| Listed Personal Property | |

# References

11-203. For more detailed study of the material in this Chapter, we would refer you to the following:

| | |
|---|---|
| ITA 82(3) | Dividends Received By Spouse Or Common-Law Partner |
| ITA 110 | Deductions Permitted |
| ITA 110.6 | Lifetime Capital Gains Deduction |
| ITA 111 | Losses Deductible |
| ITA 111.1 | Order Of Applying Provisions |
| ITA 118.1 | Charitable Gifts |
| ITA 120.2 | Minimum Tax Carry Over |
| ITA 127.5-.55 | Obligation To Pay Minimum Tax |
| IC 75-23 | Tuition Fees And Charitable Donations Paid To Privately Supported Secular and Religious Schools |
| | |
| S4-F8-C1 | Business Investment Losses |
| S5-F2-C1 | Foreign Tax Credit |
| S7-F1-C1 | Split-receipting and Deemed Fair Market Value |
| | |
| IT-113R4 | Benefits To Employees — Stock Options |
| IT-226R | Gift To A Charity Of A Residual Interest In Real Property Or An Equitable Interest In A Trust |
| IT-232R3 | Losses - Their Deductibility In The Loss Years Or In Other Years |
| IT-244R3 | Gifts By Individuals Of Life Insurance Policies As Charitable Donations |
| IT-288R2 | Gifts Of Capital Properties To A Charity And Others |
| IT-295R4 | Taxable Dividends Received After 1987 By A Spouse |
| IT-322R | Farm Losses |
| IT-523 | Order Of Provisions Applicable In Computing An Individual's Taxable Income And Tax Payable |

# Appendix - Returns For Deceased Taxpayers

## Special Rules At Death

### Coverage In Text

11A-1. Filing requirements on the death of an individual can be very complicated and complex, especially if the individual left a significant amount of various types of assets. There are a number of special rules that are applicable when an individual dies. Some of these are covered in various chapters in the text. The following is a short summary of the special rules covered in the text, as well as where more information related to the rules can be found in the text. This Appendix also covers the special filing requirements and elective returns for deceased taxpayers. Note that death benefits are income of the recipient and have no effect on the final return of the deceased. Death benefits are covered in Chapter 9.

### Charitable Donations - Special Rules At Death

11A-2. Charitable donations made in the year of death, or through bequests in the will and carried out by the executors of the will, can be claimed for tax credit purposes subject to a limit of 100 percent of Net Income, as opposed to the normal limit of 75 percent. Any charitable donations that are not claimed in the final return can be carried back to the immediately preceding year, subject to the 100 percent of Net Income limit.

### Medical Expenses - Special Rules At Death

11A-3. Medical expenses paid can normally be claimed for any 12 month period ending in the year to the extent they exceed a threshold amount (see Chapter 4). In the year of death, the time period is extended to the 24 month period prior to death.

### Deemed Disposition Of Capital Property At Death

11A-4. The deceased taxpayer is deemed to have disposed of capital property at fair market value immediately before his death. When the capital cost of a depreciable property for the deceased taxpayer exceeds its fair market value, the beneficiary is required to retain the original capital cost, with the difference being treated as deemed CCA.

11A-5. An exception to the general rules is available where the transfer is to a spouse, a common-law partner, or a testamentary spousal or common-law partner trust. This is a rollover provision that allows the transfer of non-depreciable property at its adjusted cost base and depreciable property at its UCC. There are other tax free transfers involving specific types of farm and fishing assets. Deemed dispositions at death are covered in Chapter 9.

### Deferred Income Plans At Death

11A-6. In many cases, a deceased individual will have a Tax Free Savings Account (TFSA), a Registered Retirement Savings Plan (RRSP) or a Registered Retirement Income Fund (RRIF) at the time of death. There are a number of special rules associated with this situation and these are covered in Chapter 9 (TFSA) and Chapter 10 (RRSP and RRIF).

### Capital Losses - Special Rules At Death

11A-7. There are special rules that apply to both net capital losses from years prior to death and to allowable capital losses arising in the year of death. These accumulated losses can be applied against any type of income in the year of death, or the immediately preceding year. Any capital gains deductions claimed to the date of death reduce the net capital losses that can be claimed on an unrestricted basis. The treatment of capital losses at death is covered in this Chapter 11.

## Representation

11A-8. The deceased do not, of course, file tax returns. However, a considerable amount of filing and other tax work may need to be done by the legal representative of the deceased. This legal representative may be an executor. This is an individual or institution appointed in the will to act as the legal representative of the deceased in handling his estate.

11A-9. In the absence of a will, or in situations where an executor is not appointed in the will, a court will generally appoint an administrator as the legal representative of the deceased. This administrator will normally be the spouse or next of kin of the deceased.

11A-10. The basic tax related responsibilities of the legal representative of an estate are as follows:

- filing all necessary tax returns;
- paying all taxes owing;
- obtaining a clearance certificate from the CRA for all tax years, before property under his control is distributed to the beneficiaries (a failure to do this can result in a personal liability for taxes owing); and
- advising beneficiaries of the amounts of income from the estate that will be taxable in their hands.

11A-11. In order to deal with the CRA in these matters, the legal representative will have to provide a copy of the deceased person's death certificate, as well as a copy of the will or other document identifying him as the legal representative of the deceased. Without this documentation, the CRA will not provide any of the deceased person's income tax information.

## Procedures For Specific Returns

### Ordinary Return(s)

11A-12. As noted previously, the legal representative of the deceased is responsible for filing a return for the year of death (a.k.a., final return) and, if required, a return for the previous year. This return would contain the usual sources of income, including employment income, business income, property income, and net taxable capital gains. With respect to employment income, it would include salary or wages from the end of the last pay period to the date of death.

> **EXAMPLE** A taxpayer dies on June 4. His last pay period is from May 16 through May 31, with the amount being payable on June 7.
>
> **ANALYSIS** The accrual for the period from June 1, the first day after the end of his last pay period, through the June 4 date of his death, must be included in his ordinary return for the year of death. With respect to the amount that is accrued but unpaid at his death, this can either be included in the taxpayer's ordinary return or, alternatively, in a separate "rights or things" return.

### Rights Or Things Return

11A-13. Rights or things are defined as unpaid amounts that would have been included in the deceased's income when they were realized or disposed of, had the taxpayer not died. Included would be:

- unpaid salaries, commissions, and vacation pay for pay periods which ended before the date of death (e.g., the salary for the period May 16 through May 31 in the example in Paragraph 11A-12)
- uncashed matured bond coupons, provided they were not required to be included in a previous year's income
- harvested farm crops and livestock on hand
- inventory and accounts receivable of taxpayers using the cash method
- declared, but unpaid dividends

11A-14. While some of these amounts could be included in the ordinary return of the taxpayer, it is generally advisable, provided the amounts are material, to file this separate return as it permits a doubling up of certain tax credits and, in many cases, will result in additional amounts being taxed at the lowest federal rate.

11A-15. Interest accrued at the time of death is somewhat problematical. If, at the time of his death, a taxpayer owns a term deposit or similar investment that pays interest on a periodic basis, ITA 70(1)(a) requires that interest accrued to the date of death be included in the

taxpayer's ordinary return of income. This would be the case even if the taxpayer ordinarily used the cash basis of interest recognition. Under ITA 70(2), any accrued interest that is required to be included in the final ordinary return cannot be included in the rights or things return.

11A-16. In contrast, if the debt instrument does not pay periodic interest, the accrued interest can be treated as a right or thing. As examples of this, IT-210R2, "Income Of Deceased Persons - Periodic Payments", Paragraph 2 refers to a matured treasury bill that has not been realized and to matured, but uncashed bond coupons as follows:

> If a deceased taxpayer owned a term deposit or other similar investment on which interest was payable periodically, interest accrued from the last date on which interest was payable up to the date of death would be included in income for the year of death under paragraph 70(1)(a). However, if the taxpayer also had on hand a matured investment (such as a matured Treasury Bill or uncashed matured bond interest coupons) at the date of death, any interest that was owing to the deceased taxpayer on the matured investment immediately before the date of death would be considered a right or thing for the purposes of subsection 70(2) to the extent the amount was not included or required to be included in the deceased's income for the year or a preceding year.
>
> For information about the tax treatment of "rights or things," refer to IT-212R3, Income of Deceased Persons — Rights or Things.

11A-17. As a final point, note that rights or things can be transferred to a beneficiary, provided this is done within the time limit for filing a separate rights or things return. If this election is made, the amounts will be included in the beneficiary's income when they are realized, and should not be included in either the ordinary, or the rights or things return of the deceased.

### Other Elective Returns

11A-18. There are other elective returns that will be given limited attention in the following material.

## Filing Requirements

### Prior Year Returns

11A-19. If an individual dies between November 1 of the prior year and the normal due date for the prior year's return (April 30 of the current year or, if the individual or his spouse or common-law partner had business income, June 15 of the current year), it is likely that he will not have filed the return for the prior year. In this situation, the due date for the prior year's return is the later of six months after the date of death and the normal filing date. For example, if an individual dies on January 31, 2019, it is unlikely that his 2018 tax return would have been filed. If his normal filing date was either April 30th June 15th, his representative would have until July 31, 2019 to file his 2018 tax return.

11A-20. Under ITA 111(2), a deceased taxpayer is allowed to deduct unused capital losses against any source of income in the year of death and the immediately preceding year. However, any capital gains deductions claimed to the date of death reduce the net capital losses that can be claimed on an unrestricted basis. Charitable donations can also be carried back to the preceding year if not needed on the final return. If either item is applied to the preceding year, the prior year's return must be amended if it has been filed.

### Multiple Returns

11A-21. Filing the appropriate tax returns in the most advantageous manner for a deceased taxpayer can be complicated as there are a number of exceptions to the normal rules. In addition, there are special rules for final returns.

11A-22. In fact, in some situations, more than one return will be filed on behalf of a deceased individual. Some of these are required by the ordinary provisions of the *Income Tax Act*. Other can be filed on the basis of an election and may or may not be filed in particular cases. The potential returns and their deadlines can be described as follows:

- **Ordinary Return - Year Of Death** The ordinary return for the year of death, also referred to as the final or terminal return, will be due on April 30 or June 15 of the subsequent year. However, if the death occurs between November 1 and December 31 of the current year, the deceased taxpayer's representative has until the later of the normal filing date and six months after the date of death to file the current year's return. For example, if a taxpayer died on December 1, 2019 and his normal filing date was April 30, 2020, his representative would have until June 1, 2020 to file his 2019 tax return. Alternatively, if his return contained business income, his normal filing date of June 15, 2020 would be applicable.

- **Elective Return - Rights Or Things** Under ITA 70(2), this special return is due the later of one year from the date of death or 90 days after the mailing date of the notice of assessment of the final return. (See Paragraph 11A-13, which explains rights or things.)

- **Elective Return - Non-Calendar Fiscal Year End** If the deceased had business income from a partnership or proprietorship with a non-calendar taxation year, the taxpayer's death may or may not create a year end for the business. Usually, this will not be the case. However, if the taxpayer's death does create a deemed year end for the business, and that year end occurs after the end of the fiscal period of the business, ITA 150(4) provides for an elective return to include the income of the business for the period between the deemed year end and the end of the calendar year. This avoids having two years of business income accruing in a single taxation year.

  For example, if Mr. Samuel Rosen had a proprietorship with a June 30 year end and he died on November 23, 2019, his representative could file a separate return for the period July 1 through November 23, 2019. This would allow the representative to limit the business income in his final return to the 12 month period ending June 30, 2019. The filing deadline for this return is the same as the one applicable to the final return.

- **Elective Return - Testamentary Trust Beneficiary** Under ITA 104(23)(d), if the deceased is an income beneficiary of a testamentary trust that has a non-calendar taxation year, the representative may elect to file a separate return for the period between the end of the trust's fiscal year and the date of the taxpayer's death. The filing deadline is the same as the one applicable to the final return.

11A-23. There are two basic reasons for filing as many tax returns as possible. The first relates to the fact that the income tax rates are progressive and income starts at nil in each return. This means that the first $47,630 (for 2019) in each return has the advantage of being taxed at the lowest federal rate of 15 percent. If multiple returns are not filed, there may be amounts taxed at rates higher than 15 percent that would have been taxed at the lower rate if multiple returns had been filed.

11A-24. The second advantage of filing multiple returns is that some personal tax credits can be deducted in each return. As will be discussed in the following material, this could save the deceased taxpayer's estate several thousand dollars for each tax return filed.

## Use Of Deductions And Credits

### Multiple Usage

11A-25. The full amount of applicable personal credits is claimed, regardless of when the individual died in the year. As previously noted, one of the major advantages of being able to file multiple returns is that some personal tax credits can be used in all of the returns filed. It appears that the rationale for claiming certain tax credits on multiple returns is to recognize

the fact that the income reported on the different returns could have been included in a later year's tax return if the deceased had lived. In that later year, personal tax credits would have been available to reduce Tax Payable.

11A-26. The CRA's Guide, "Preparing Returns For Deceased Persons" (T4011) provides a great deal of information relevant to the returns of deceased taxpayers. In the Guide, it notes that there are three groups of amounts that can be claimed on optional returns. More specifically, the following non-refundable credits can be claimed in the final return and in each optional return filed:

- basic personal credit
- age credit
- spousal credit (including infirm amount if applicable)
- credit for an eligible dependant (including infirm amount if applicable)
- Canada caregiver for a child under 18 credit
- Canada caregiver credit

11A-27. The combined value of these federal tax credits, if applicable, can represent a significant tax savings if multiple tax returns can be filed. There are similar credits available in the various provinces. Achieving these savings is, of course, conditional on each of the individual returns having sufficient Tax Payable to make use of the credits.

### Elective Usage

11A-28. Other non-refundable credits can be split between, or deducted in full, in any of the returns filed. However, the total claimed cannot exceed the amount that would be included in the ordinary return for the year of death. These credits include the following:

- adoption expenses
- disability amount for the deceased person
- disability amount for a dependant other than a spouse
- tuition amount for the deceased person
- tuition amount transferred from a child
- interest paid on certain student loans
- charitable donations, including amounts gifted in the will (limited to 100 percent of Net Income)
- first time home buyer's amount
- medical expenses (note that the total expenses must be reduced by the lesser of $2,352 (2019 figure) and 3 percent of the total Net Income reported on all returns)

### Usage With Related Income

11A-29. With respect to the following deductions and non-refundable credits, they can only be claimed in the return in which the related income is reported:

- Canada or Quebec Pension Plan contributions credit
- Employment Insurance premiums credit
- Canada Employment credit
- pension income credit
- dividend tax credits
- stock option deduction
- social benefits repayment (clawback)

### Usage With Ordinary Return

11A-30. Deductions and credits that cannot be claimed on elective returns are claimed on the final return. The following deductions and non-refundable credits are listed in the CRA Guide as amounts that cannot be claimed on an optional return, but that can be claimed in the deceased's ordinary final return (it is not a complete list):

- Registered Pension Plan deduction
- Registered Retirement Savings Plan deduction
- annual union or professional dues
- amounts transferred from a spouse or common-law partner
- child care expenses
- carrying charges and interest expenses
- disability supports deduction
- allowable business investment losses
- moving expenses
- support payments made
- losses from other years
- lifetime capital gains deduction
- northern residents deduction
- exploration and development expenses

## Payment Of Taxes

11A-31. Regardless of the extension of filing dates for the final and elective returns, the tax owing is normally due on April 30 of the year following the year of death. We would also remind you that the due date for payment of taxes is unchanged by the deferral of the normal filing date to June 15 for taxpayers with business income.

11A-32. However, if death occurs between November 1 of the prior year and April 30 of the current year, the due date for the payment of taxes is six months after the date of death.

11A-33. With respect to income from the value of rights or things and from deemed dispositions of capital property at death, the legal representative for the deceased individual can elect to defer the payment of taxes. Under ITA 159(5), payment can be made in ten equal annual instalments, with the first payment due on the regular payment due date of the final return. Security acceptable to the Minister must be furnished to guarantee payment of the deferred taxes. Interest will be charged on amounts outstanding and, as is the usual case, such interest is not deductible.

# Sample Tax Return And Tax Software SS Problem

The Chapter 11 Sample Tax Return and the Tax Software Self Study Problem for Chapter 11 can be found in the print and online Study Guide.

# Problems For Self Study (Online)

To provide practice in problem solving, there are Self Study and Supplementary Self Study problems available on MyLab Accounting.

Within the text we have provided an indication of when it would be appropriate to work each Self Study problem. The detailed solutions for Self Study problems can be found in the print and online Study Guide.

We provide the Supplementary Self Study problems for those who would like additional practice in problem solving. The detailed solutions for the Supplementary Self Study problems are available online, not in the Study Guide.

The .PDF file "Self Study Problems for Volume 2" on MyLab contains the following for Chapter 11:

- 11 Self Study problems,
- 6 Supplementary Self Study problems, and
- detailed solutions for the Supplementary Self Study problems.

# Assignment Problems

(The solutions for these problems are only available in the solutions manual that has been provided to your instructor.)

### *Assignment Problem Eleven - 1*

***(Loss Carry Overs - Individual)***

Over a four year period ending on December 31, 2019, Ms. Brenda Breau had the following financial data:

| | 2016 | 2017 | 2018 | 2019 |
|---|---:|---:|---:|---:|
| Business Income (Loss) | $18,000 | ($14,000) | $30,000 | ($19,000) |
| Farming Income (Loss) | ( 10,000) | 2,000 | 3,150 | ( 2,000) |
| Taxable (Grossed Up) Dividends | 2,360 | 2,950 | 3,963 | 6,450 |
| Capital Gains | 1,200 | 2,000 | 4,000 | 4,500 |
| Capital Losses | ( 4,200) | Nil | Nil | ( 14,500) |

Because of the nature of her farming activities, Ms. Breau's farm losses are restricted. The dividend income is from taxable Canadian corporations and the amount includes the gross up.

When she has a choice, she would like to deduct the maximum amount of her net capital loss carry overs and carry back any losses to the earliest possible year. None of Ms. Breau's losses can be carried back before 2016.

Assume that Ms. Breau requires $14,000 in Taxable Income in each year to fully utilize her tax credits.

**Required:** Calculate Ms. Breau's minimum Net Income For Tax Purposes and Taxable Income for each of the four years. In applying carry over amounts, do not reduce Ms. Breau's Taxable Income below $14,000, the amount required to fully utilize her tax credits. Indicate the amended figures for any years to which losses are carried back. Also indicate the amount and types of loss carry overs that would be available at the end of each year.

## Assignment Problem Eleven - 2

### (Allowable Business Investment Losses)

In 2016, after several years of working part time at McDonald's, Lucinda McIvor was fortunate enough to win a lottery prize of more than $1,000,000. She quickly blew through over $100,000 of this on recreational drugs, alcohol, and luxury travel. However, in early 2017 after an overdose that very nearly ended her life, Lucinda checked herself into rehab and emerged from treatment a changed woman.

She embarked on a program of actively investing in rental properties, and in the shares and debt of small private companies. Her investment income during the three years 2017 through 2019 were as follows:

**2017** During this year she realized a large capital gain on the sale of shares in a wildly successful, qualified small business corporation. She used $156,000 of her lifetime capital gains deduction to reduce her 2017 Taxable Income to be equal to her basic personal amount leaving her with a nil Tax Payable.

**2018** During this year she had the following amounts of income:

| | |
|---|---:|
| Taxable Capital Gains | $ 17,300 |
| Net Rental Income | 91,450 |
| Interest Income | 38,275 |
| Total | $147,025 |

**2019** Income amounts during this year were as follows:

| | |
|---|---:|
| Taxable Capital Gains | $ 18,620 |
| Net Rental Income | 86,300 |
| Interest Income | 27,438 |
| Total | $132,358 |

During 2019, Recovery Inc., a small business corporation to which she had extended a loan of $675,000, went into bankruptcy. Lucinda has been advised that it is extremely unlikely that she will recover any of this amount. Given this, Lucinda is writing off the entire balance.

The only tax credit available to Lucinda in 2018 or 2019 is the basic personal credit (basic personal amount of $11,809 in 2018 and $12,069 in 2019). For several years prior to 2017, Lucinda's Tax Payable was eliminated by various credits. She did not have any loss carry forwards from years prior to 2019.

**Required:** Determine Lucinda's optimum Taxable Income for the years ending December 31, 2018 and December 31, 2019. In your solution, consider the effect of the basic personal credit. Indicate any loss carry over that is present at the end of either year, and the rules applicable to claiming the loss carry over.

## Assignment Problem Eleven - 3

### (ABILs and Lifetime Capital Gains Deduction)

The following information is for Dirk Flack for the year ending December 31, 2019:

- Dirk had net rental income of $187,000.
- Dirk sold shares of Stix Inc., a qualified small business corporation, for $360,000. The adjusted cost base of these shares was $57,000. Selling costs were $2,000.
- Dirk sold shares of Sugrass Inc., a small business corporation that did not qualify for the lifetime capital gains deduction. The shares had cost $295,000. The net proceeds of disposition were $71,000.
- At the end of 2019, Dirk had a Cumulative Net Investment Loss of $3,600.
- On January 1, 2019, Dirk had a net capital loss carry forward of $6,400 [(1/2)($12,800)].

Dirk has used the ITA 110.6 lifetime capital gains deduction to eliminate a 2014 capital gain of $78,500, as well as a 2016 capital gain of $39,000. Dirk has not deducted any other amounts under ITA 110.6 in the years prior to 2019.

**Required:** Calculate Dirk's minimum Net Income For Tax Purposes and Taxable Income for 2019. Provide all of the calculations required to determine the maximum ITA 110.6 deduction assuming:

A. Dirk would prefer to make the maximum deduction of his net capital loss carry forward, prior to making any use of the lifetime capital gains deduction.

B. Dirk would prefer to make the maximum use of the lifetime capital gains deduction.

### *Assignment Problem Eleven - 4*

#### *(Tax On Split Income)*

In the following five cases, one or more taxpayers receive dividends from a private company. For each taxpayer, determine whether the dividends received will be classified as Split Income. Explain your conclusion.

**CASE 1** Sam and Sandra are both 23 years old and have been married for five years. They each own 50 percent of the shares of Mobus, a corporation that is actively involved mobile applications. The shares were acquired, in return for a nominal investment, when the corporation was formed. All of the shares have the same fair market value and the same voting rights.

Sam works full time for another corporation, while Sandra has a part time job in health care. They both spend time managing and operating Mobus. Neither Sam nor Sandra work more than 20 hours per week in the business. However, the nature of the corporation's business is such that additional employees are not required.

During 2019, because one of its applications has been very successful, Mobus is able to pay dividends of $200,000, with Sam and Sandra each receiving $100,000.

**CASE 2** GoGreen is a Canadian private corporation that runs a seasonal landscaping business. The business operates from May 1 through September 30. Ninety percent of the shares are owned by John Go, with his twin children, Max and Mary Go, owning the remaining 10 percent (5 percent each).

The twins are 22 years old and attending university in another city during the period from mid-September until the end of April. During the period May through mid-September, they work full time with their father in operating the GoGreen business.

During 2019, each twin receives $10,000 in dividends from GoGreen.

**CASE 3** Edward and Elsie Cole were married in 2006. Elsie has been the family's primary bread winner, a role she satisfied by operating Cole Industries, a Canadian private company involved in an active business. Elsie was the sole shareholder of this company and worked full time in its operations. In late 2018, citing irreconcilable differences, the couple was divorced.

As part of the settlement agreement, Elsie was required to have Cole Industries issue a second class of shares to Edward. During 2019, as required by the divorce decree, these shares pay dividends to Edward in the amount of $50,000.

**CASE 4** Larry and Louise Martin own respectively 95 percent and 5 percent of the shares of Musken Enterprises, a Canadian private company. Larry is 66 years old and Louise is 59 years old. They have been married for over 20 years.

From 2006, when Musken started operations, until 2018, Larry worked full time in the business. In 2018, Larry retired and turned the operation of the business over to a salaried manager. Louise has never been involved in the business.

During 2019, Musken pays dividends of $190,000 to Larry and $10,000 to Louise.

**CASE 5** Donald Rump owned all of the shares of Dontar during the period 2011 through 2018. Dontar is a private Canadian company involved in an active business in manufacturing. Donald has worked full time in the business since its inception in 2011.

After graduating from high school at 18 years of age, Donald's son David worked full time in the business during the years 2016 through 2018. However, in January, 2019, he enrolled in a full time university program and no longer spends any time working in the business. He is 22 years old at the end of 2019.

In late 2018, in order to assist David with the cost of attending university, Donald issues a second class of shares to his son. David uses his savings to acquire the shares. These new shares have a fair market value equal to 20 percent of the total value of all outstanding shares, pay dividends at an annual rate of 5 percent and are non-voting. Assume that the basic prescribed rate is 2 percent throughout 2019.

During 2019, Dontar pays $105,000 in dividends to Donald and $6,000 in dividends to David.

## *Assignment Problem Eleven - 5*

### *(Transfer Of Credits And Pension Income Splitting)*

Mr. and Mrs. Bahry have been retired for several years. They are both in their early seventies, residents of Canada, and rely on pension income to provide for most of their needs. More specifically, the components of their income for the year ending December 31, 2019 are as follows:

| | Mr. Bahry | Mrs. Bahry |
|---|---|---|
| Old Age Security Benefits | $ 7,400 | $7,400 |
| Receipts From Registered Pension Plan | 12,340 | 820 |
| Receipts From Registered Retirement Income Fund | N/A | 1,000 |
| Canada Pension Plan Receipts | 3,690 | 830 |
| Eligible Dividends Received From Canadian Public Corporations (100%) | 1,600 | 336 |
| Interest On Savings Accounts | 1,239 | 2,500 |
| Charitable Donations | 1,210 | 300 |
| Capital Gain On Sale Of Painting | N/A | 500 |
| Capital Loss On Sale Of Public Company Shares | 3,975 | 820 |

**Required:**

A. Assume that Mr. and Mrs. Bahry do not elect to use the pension income splitting provisions. Determine the Taxable Income for both Mr. and Mrs. Bahry and the maximum federal tax credits that will be available to Mr. Bahry for the 2019 taxation year. Also indicate the amount and types of any loss carry overs that would be available to Mr. and Mrs. Bahry at the end of 2019.

B. If Mr. and Mrs. Bahry jointly elect to split the pension income, what objectives should they try to accomplish with the pension income split? (No calculations are required.)

## Assignment Problem Eleven - 6

### (Alternative Minimum Tax And RRSP Calculations)

Cheryl Delancey, a tax consultant, has provided tax assistance on a regular basis to her two aunts, Alma and Irene Delancey. For the 2019 taxation year, Cheryl and her aunts are concerned about the impact of the alternative minimum tax on the amount of tax they will have to pay. In order to estimate the tax that will be payable, they each have estimated the amounts and types of income they expect to earn, and deductions to claim, for 2019. These estimates are as follows:

| | Cheryl | Alma | Irene |
|---|---:|---:|---:|
| Employment And Business Income | $60,800 | $42,000 | $ 22,900 |
| Non-Eligible Dividends Received From Canadian Corporations | 26,300 | Nil | 29,400 |
| Taxable Capital Gains | 9,100 | Nil | 450,000 |
| Lifetime Capital Gains Deduction Claimed | 9,100 | Nil | 375,000 |
| Retiring Allowance | Nil | 58,000 | Nil |
| RRSP Contributions | 3,500 | 58,000 | Nil |

On Cheryl's 2018 T4, a Pension Adjustment of $8,600 was reported. Assume that her 2018 Earned Income equals her 2019 Earned Income. She has no Unused RRSP Deduction Room or undeducted RRSP contributions at the end of 2018.

As Alma had worked for her present employer for over 48 years, she is eligible for a tax free rollover of the entire retiring allowance to an RRSP.

All taxable capital gains relate to the sale of shares of qualified small business corporations.

Ignore the EI, CPP, and Canada Employment tax credits. Assume that the only tax credits available to the Delancey women are their basic personal tax credits and dividend tax credits related to dividends received.

**Required:** Calculate the minimum regular 2019 federal Tax Payable for each of the three women, as well as the alternative minimum tax amount.

## Assignment Problem Eleven - 7

### (Death Of A Taxpayer)

### Family Information

On July 7, 2019, Mrs. Rachelle Flax was killed in an automobile accident. At the time of her death, Rachelle was 47 years old. She is survived by her 44 year old husband, Martin Flax and her 24 year old daughter, Roxanne Flax.

Martin has spent most of his adult life volunteering for worthy causes. During 2019, he has employment income of $2,100 that was paid to him for services performed for Rachelle's unincorporated business prior to her death, as well as $1,700 in interest income. This interest was earned on a guaranteed investment certificate that had been given to him by Rachelle several years ago.

Roxanne is a very successful home decorator and is not a dependant of Rachelle.

### Business Income

For several years, Rachelle has been the proprietor of a dog boutique and restaurant. The business had a December 31 fiscal year end. Until the date of her death, the proprietorship had net business income for tax purposes of $69,400. At the time of her death, the fair market value of the business assets was $5,900 greater than their UCC. None of the individual assets had fair market values that exceeded their capital cost.

As noted, prior to her death, the business had paid her husband, Martin a total of $2,100. This was for serving as bartender in the restaurant for discerning dogs. As Martin did not feel capable of carrying on the business on his own, he immediately sold the assets for their fair market value to a regular customer.

### Rental Property

Rachelle had owned a residential rental property for 5 years prior to her death. In 2019, prior to her death, the property had rents of $46,300 and expenses other than CCA of $31,400. The property had been purchased for $312,000, of which $210,000 was allocated to the building and $102,000 to the land. An appraisal indicated that, at the time of her death, the total value of the property was $355,000, which was allocated $243,000 to the building and $112,000 to the land. At January 1, 2019, the building had a UCC of $174,795.

Rachelle's will leaves this property to her daughter, Roxanne.

### Investments And Other Assets

Information related to the other assets that Rachelle owned at the time of her death is as follows:

**Art Collection** Rachelle had collected Inuit art for a number of years. Her collection had an adjusted cost base of $23,400. At the time of her death, the fair market value of the collection was $57,000. The collection was left to her daughter who immediately sold the collection for its fair market value of $57,000.

**Jewelry** Over the years, Rachelle had spent $32,000 on various pieces of jewelry. At the time of her death, their fair market value was only $8,300. The collection was left to her daughter who immediately sold them for their fair market value of $8,300.

**Shares In RAF Ltd.** RAF Ltd. is a Canadian public company. The common shares were purchased for $12,400 and, prior to her death, paid Rachelle eligible dividends of $860. At the time of her death, their fair market value was $28,600. Her will leaves these shares to the Humane Society. The Humane Society issues a charitable donation receipt for $28,600 on receiving the shares.

**Shares In Flax Fittings Inc.** This is a company that was started by Rachelle's father with an investment of $20,000. He left all of the shares to Rachelle in his will. At that time, their fair market value was $72,000. Prior to her death, the shares paid Rachelle non-eligible dividends of $6,200. At the time of her death, their fair market value was $104,000. The shares are not eligible for the lifetime capital gains deduction. Her will leaves these shares to Martin.

**RRSP** At the time of her death, Rachelle had an RRSP with a total fair market value of $1,123,000. Martin is named as beneficiary of the RRSP.

**Family Residence** The family home is in Rachelle's name only. It had been purchased at a cost of $382,600. At the time of her death, the appraised value of the property was $507,000. This property is left to Martin.

### Other Information

At the time of her death, Rachelle had a net capital loss carry forward of $89,400 and a listed personal property loss carry forward (100 percent) of $5,400. Rachelle has never claimed the lifetime capital gains deduction.

Due to her business income, Rachelle will pay the maximum CPP contributions for a self employed proprietor.

The terms of Rachelle's will requires the executor of her estate to elect out of the ITA 70(6) spousal rollover in the case of all properties bequeathed to Martin.

**Required:** Calculate Rachelle's minimum Net Income For Tax Purposes for the 2019 taxation year, her minimum Taxable income for that year, and her 2019 federal Tax Payable.

## Assignment Problem Eleven - 8

### (Comprehensive Tax Payable With Donations)

#### Family Information

Lyla and Clark Beaston are both 45 years of age. They have been happily married for 23 years. When they first met, they found that they both shared a strong dislike for dogs, cats and small children. Given this, they have no children and have never had a pet.

Both of them are lawyers and have had very successful careers in a variety of jobs. At this point, their net worth is over $5 million. Lyla is currently employed by a large public company. While Clark has been an employee in the past, he currently spends his time managing the family's investments. For a variety of reasons, all of these investments are solely owned by Clark.

While both Lyla and Clark enjoy generally good health, Clark has significant back problems related to a childhood accident. As these have worsened in recent years, in 2019, he decides to go to a clinic in the U.S. for surgery. The total cost of this surgery is US$52,000. At the time of this surgery, the exchange rate was US$1.00 = C$1.35, providing a translated value of $70,200. The travel costs associated with this surgery were US$8,000, resulting in a translated value of $10,800. Clark's Canadian doctor has provided a letter indicating that a similar surgery would have required a wait time of at least two years in Canada.

The couple have qualifying medical expenses in Canada consisting of prescriptions and regular dental work of $4,800.

Because they attribute much of their success to the excellent education they received at the University of Toronto, they make a 2019 donation of $175,000 to this institution when Clark receives a large and unexpected inheritance. As a result of this donation, they do not make their annual donation to the Canadian Cancer Society, or any other donations during the year.

#### Lyla's Employment information

Lyla's gross salary for 2019 is $270,000. Her employer withholds the maximum 2019 contributions to Employment Insurance ($860) and the Canada Pension Plan ($2,749). She does all of her work in her employer's office and is not required to travel. Given this, she has no deductible travel or other employment related expenses.

Her employer sponsors a defined benefit pension plan. Her contribution, which is withheld from her salary payments, is $12,450. Her employer makes a matching contribution.

Her employer provides a group disability plan for its employees. The 2019 premium on this plan is $2,500, one-half of which is paid by Lyla through withholdings. Her employer also provides for a generous medical insurance plan that covers 100 percent of any prescription costs and dental fees paid in Canada by employees for themselves or their families.

#### Clark's Investment Results

During 2019, the results for the investments that Clark manages are as follows:

| | |
|---|---:|
| Interest | $ 28,600 |
| Eligible Dividends From Canadian Public Companies | 136,000 |
| Net Taxable Capital Gains | 77,000 |

In order to increase his investment holdings, Clark assumed a mortgage on the family residence. This residence had been purchased for cash and, at the time the mortgage was arranged, there was no debt on the property. The proceeds of the mortgage were immediately invested in shares of Canadian public companies. Interest on the mortgage for 2019 was $12,000.

**Required:**

A. Determine the combined federal Tax Payable for Lyla and Clark, assuming that Lyla claims all of the medical expenses and all of the charitable donations.

B. Determine the combined federal Tax Payable for Lyla and Clark, assuming that Clark claims all of the medical expenses and all of the charitable donations.

C. Determine whether there is an allocation of medical expenses and charitable donations that would produce a lower combined federal Tax Payable than either the Part A results or the Part B results. Show your calculations.

## Assignment Problem Eleven - 9

### (Comprehensive Personal Tax Payable)

On January 10, 2019, Ms. Arlene Arsenault formally separated from her husband and retained custody of her 15 year old son, Jerry. Jerry has no income during 2019. Ms. Arsenault is also responsible for her 20 year old daughter, Janine, who has a severe and prolonged disability (a medical doctor has certified her disability on Form T2201). Janine has 2019 income of $6,000, resulting from income on investments that were left to her by her grandmother.

In order to get a fresh start in life, Ms. Arsenault found a new job. She resigned from her position in Ottawa and moved to a similar position in Toronto. The move took place on October 31, 2019. She has asked for your assistance in preparing an estimate of her 2019 personal tax liability and, in order to assist you with your calculations, she has prepared the following list of transactions that occurred during 2019:

1. Her gross salary from her Ottawa employer, a large public company, for the first 10 months of the year was $82,000. Her employer withheld from this amount CPP contributions of $2,749, EI premiums of $860, and RPP contributions of $2,500. The employer also contributed $2,500 to the company's RPP on her behalf.

   Before leaving her Ottawa employer, she exercised stock options to acquire 2,000 of the company's shares at a price of $15 per share. The options were issued in 2018, when the market price of the shares was $12 per share. On August 12, 2019, the day that she exercised the options, the shares were trading at $20 per share. Ms. Arsenault sells the shares as soon as she acquires them. Brokerage fees totalled $350 on the sale.

2. During November and December, her gross wages with her Toronto employer amounted to $13,000. Her new employer withheld CPP contributions of $500, EI premiums of $390, and $650 in RPP contributions. Her Toronto employer also contributed $650 to the company's money purchase RPP on her behalf.

   Ms. Arsenault found a new home in Toronto during her September house hunting trip there. The legal arrangements for the house purchase were finalized on October 10. In Ottawa, she and her husband had lived for 10 years in a home that they rented. Her agreement with her new employer requires that they pay her moving costs. In order to simplify the record keeping, the employer paid her an allowance of $7,500 and did not require a detailed accounting of expenses. Her actual expenses were as follows:

   | | |
   |---|---:|
   | Moving company charges | $3,800 |
   | Airfare for September Toronto trip to acquire new home | 350 |
   | Meals and lodging on September Toronto trip | 275 |
   | Gas for October 31 move to Toronto | 65 |
   | Lodging in Ottawa on October 30 | 110 |
   | Meals on October 30 and October 31 While Moving | 250 |
   | Charges for cancellation of lease on Ottawa home | 935 |
   | Legal and other fees on acquisition of Toronto home | 1,500 |
   | Total | $7,285 |

   Ms. Arsenault did not use the simplified method of calculating vehicle expenses and moving costs.

3. In 2016, Ms. Arsenault's mother died, leaving her 5,000 shares of Linz Industries, a private company. These shares had cost her mother $50,000, and had a fair market value

at the time of her death of $95,000. Ms. Arsenault received non-eligible dividends of $7,500 on these shares in May and, in December, she sells the shares for $105,000. Selling costs were $850.

4. Ms. Arsenault made $1,500 in donations to a registered Canadian charity and $900 in contributions to the Libcon Rebloc Party, a registered federal political party.

5. Ms. Arsenault incurred the following child care costs:

| | |
|---|---|
| Payments To Individuals For Jerry And Janine | $7,160 |
| Fees For Jerry To Attend Camp (4 Weeks At $200 Per Week) | 800 |
| Food And Clothing For The Children | 6,400 |
| Total | $14,360 |

6. Ms. Arsenault paid the following medical expenses:

| | |
|---|---|
| For Herself | $ 9,700 |
| Jerry | 900 |
| Janine | 7,250 |
| Total | $17,850 |

7. In previous years, Ms. Arsenault's husband took care of her financial affairs. She has no understanding of either RPPs or RRSPs, but will make the maximum deductible RRSP contribution for 2019 as soon as you have calculated it. Her RRSP Deduction Limit Statement from the CRA states that her 2018 Earned Income was $81,100 and that, at the end of 2018, she had no Unused RRSP Deduction Room. Her 2018 T4 from her employer indicates a Pension Adjustment of $4,500. There are no undeducted contributions in her RRSP.

8. During the year, Ms. Arsenault paid legal fees of $2,500 in connection with her separation agreement. This settlement requires her husband to make a lump sum payment of $25,000 on March 1, 2019, as well as child support payments of $4,000 at the end of each month beginning on January 31, 2019. All required payments were received for the year.

9. In addition to her employment income, Ms. Arsenault operates an unincorporated mail order business with a December 31 year end. Her net business income for 2019 totaled $22,500. Included in this amount is a deduction of $950 for interest that she paid on a demand loan taken out to finance inventory purchases. During the year ending December 31, 2019, Ms. Arsenault withdraws $27,000 from the bank account maintained by the business.

10. Ms. Arsenault's father owns and operates a very successful CCPC. In 2018, he gave Arlene a block of non-voting shares in his company. During 2019, these shares paid non-eligible dividends to Arlene in the amount of $10,000. Arlene has never been involved in this company's activities.

**Required:**

A. Determine Ms. Arsenault's minimum Net Income For Tax Purposes and her minimum Taxable Income for 2019. Ignore any HST considerations. In the Net Income For Tax Purposes calculation, provide separate disclosure of:

- Net Employment Income,
- Net Business And Property Income,
- Net Taxable Capital Gains,
- Other Sources Of Income, And
- Other Deductions From Income.

B. Based on your answer to Part A, calculate Ms. Arsenault's minimum federal Tax Payable and any other amounts owing to (refundable from) the CRA for 2019. Ignore any income tax withholdings that her employers would have made.

## Assignment Problem Eleven - 10

### (Comprehensive Tax Payable)

Jane Shipley, age 44 is a single parent of one child, 8 year old Jack. Jack lives full time with Jane as his father returned to England after the couple divorced. Jane has provided you with the following information about her income and expenses for 2019:

1. Jane owned all the shares in Musical Notes Inc., a CCPC, until August 31, 2019, when she sold them for $575,000. Jane incorporated the company in 2005, and at that time, she invested $100 in the shares she acquired. No one else has ever owned any of the shares in the company. Over the years, the company, which began with one small store selling musical instruments and other music related items, was very successful, and by the time the company shares were sold, there were two stores, both with an excellent reputation.

   The company operated entirely in Canada, and has never had any income that wasn't active business income. Jane has used $100,000 [(1/2)($200,000)] of her lifetime capital gains deduction in the past when she realized a capital gain on qualifying shares. You have correctly calculated Jane's CNIL balance at the end of the year to be $20,000.

2. It has been Jane's lifelong dream to form a jazz quartet and go on tour. She found the right people to work with 5 years ago, and in September of 2019, the quartet released their first album. She has spent the fall writing music and arranging performance dates for 2020. Jane's royalties received during 2019 from the company that produced and marketed the quartet's album totaled $40,000. All expenses of the quartet are paid for by the producer.

3. Jane has a notice of assessment for 2018 which indicates the following carry forward balances:

   | | |
   |---|---|
   | Net Capital Loss [(1/2)($4,000)] | $2,000 |
   | Listed Personal Property Loss (100%) | 500 |

4. Jack is enrolled in a before and after school care program operating at his school. The cost of his care for 2019 was $3,500.

5. Medical expenses for the family were very high this year, as Jack required oral surgery, followed by extensive dental work. The total cost, paid entirely by Jane was $20,000. No other medical costs were incurred.

6. When Jane first made the decision to sell her shares in her company, she realized that she would no longer need the vacant land near her downtown store that she owned personally. She had been renting the land to a parking lot operator and had made a minimal profit each year. The land had originally cost her $25,000. As the area was undergoing some significant developments, Jane sold the lot for $175,000 in early January, 2019. During her ownership period, she paid $12,650 in taxes on the land.

7. While cleaning out her stores prior to giving the keys to the new owners, Jane found a painting that she had purchased years ago and put away in a storeroom. The painting cost her $200, and was purchased from a struggling musician who was also a watercolor painter. Since she had purchased this piece, the artist had become extremely well known internationally, and when Jane had the work appraised, it turned out it was worth $50,000. Since Jane was not going to be home much to enjoy the painting, she decided to sell it at auction, and it sold for its appraised value.

8. Prior to selling her shares in the business, Jane received a salary of $150,000 from which CPP of $2,749 was deducted. As Jane was the sole shareholder in the company, her earnings are not insurable for EI purposes.

9. Jane continues to own 15 percent of the shares in Shipley Enterprises Limited, a family corporation started by her parents. This company is a CCPC, and Jane received a non-eligible dividend from it in 2019 of $60,000. When Jack was born, he was given shares that were owned by his grandmother. As a result, he owns 5 percent of the shares in this corporation. He received non-eligible dividends of $20,000. His only income during 2019 consisted of these dividends.

10. Jane receives child support of $1,000 per month from her ex-husband. She is saving this money to use to pay for university tuition costs for Jack in the future. All of the money received has been placed directly in a U.K. bank account in her name. In 2019, this account earned the Canadian dollar equivalent of $500 in interest. A total of $50 was withheld by the British government, so that the net amount received was $450.
11. Jane took several trips out of the country in 2019 and purchased the local foreign currency before leaving Canada. As a result, for 2019, she had $700 in gains on foreign currencies and $100 in losses when she converted the foreign currencies back into Canadian dollars. She had no capital transactions that involved foreign currency.
12. Over the years, Jane had personally collected vinyl records, vintage sheet music and a great deal of music memorabilia. She had kept meticulous records and found that she had spent $36,500 purchasing these items. Jane had them appraised and was disappointed to learn that her collection was worth only $17,500. She donated everything to the music school at the local university in 2019 receiving nothing in return except a donation receipt for the maximum amount possible.

Jane is interested in your advice with respect to her RRSP and TFSA. She has $340,000 in her RRSP as of December 31, 2018. During 2019 she made a fully deductible contribution of $9,500. She also has $62,500 in her TFSA.

Because of the sale of Musical Notes Inc., Jane currently has large cash resources. However, she anticipates that it may take several years for her activities as a musician to prove as financially rewarding as her former business activities.

For the last 5 years, she has been a tenant in a modest townhouse. Within six months she is planning to buy a condo large enough to accommodate her grand piano. Since she does not want to live with any debt (such as a mortgage), this raises the possibility of a need for additional cash. If this is the case, she would like your advice on whether the required funds should be withdrawn from her RRSP or from her TFSA.

**Required:** In determining the following amounts, ignore GST, PST and HST considerations and show all your calculations.

A. For the 2019 taxation year, calculate Jack Shipley's minimum:
   1. Net Income For Tax Purposes,
   2. Taxable Income,
   3. Federal Tax Payable.

B. For the 2019 taxation year, calculate Jane Shipley's minimum:
   1. Net Income For Tax Purposes,
   2. Taxable Income,
   3. Federal Tax Payable, including Alternative Minimum Tax if applicable.

C. What advice would you give Jane regarding her concerns with respect to her potential need for additional cash in the next few years?

## Assignment Problem Eleven - 11
## (Comprehensive Case Covering Chapters 1 to 11)

### Family Information

Adam Huffer is 42 years old. His wife, Estelle Huffer is 38 years old. They have been married for 19 years. They have a daughter, Portia, who is 15 years old and in good health.

Portia, who is very precocious, began attending university on a full time basis in September, 2019. Her only income for the year is $3,400 that she earned in various part time jobs. Adam has paid her $5,400 tuition fee for the fall semester, as well as $450 for required textbooks, and $2,400 for her residence fees. As her income is less than the basic personal tax credit, she has agreed to transfer her tuition credit to her father.

Adam and Estelle's only surviving parent is Adam's father, Jack. While he does not qualify for the disability tax credit, he is dependent on Adam and Estelle because of his limited mobility. He is 69 years old and lives with them. His 2019 Net Income For Tax Purposes is equal to $12,300, including OAS payments and a small pension from a former employer. Adam claims any available personal credit for Jack.

Adam serves as a volunteer fireman. During 2019 he spent over 300 hours in this work, for which he received no compensation. Because he was convicted of arson when he was a juvenile, he feels that this volunteer work, at least partially, makes up for some of the damage he did in his teen years.

For many years, Adam has owned a small office building that he rented to the Red Cross. On January 1, 2019, he donates this building to that organization, receiving a tax receipt from them for its fair market value of $325,000. This estimated value is made up of $250,000 for the building and $75,000 for the land. Adam's capital cost for the property of $210,000 was made up of $150,000 for the building and $60,000 for the land. On January 1, 2019, the UCC of the building was $119,859. Adam would like to use the maximum amount of this credit during the current taxation year.

During 2019, Adam paid for medical and dental services as follows:

| | |
|---|---:|
| Root Canal Fee - Adam | $ 1,350 |
| Teeth Cleaning - Adam And Estelle | 360 |
| Psychological Counseling For Portia | 820 |
| Teeth Whitening For Portia | 625 |
| Breast Enhancement Surgery For Portia | 8,450 |
| Prescription Glasses For Estelle And Portia | 500 |
| Electric Wheelchair For Jack | 4,200 |
| Total | $16,305 |

Estelle will claim the credit for qualifying medical expenses.

### Adam's Employment Information

Adam works for a large Canadian public company. As CEO, his 2019 salary is $350,000, none of which is commissions. The amounts withheld by his employer during 2019 are as follows:

| | |
|---|---:|
| Registered Pension Plan Contributions* | $12,300 |
| EI Premiums | 860 |
| CPP Contributions | 2,749 |

*Adam's employer makes a matching contribution of $12,300.

As CEO, Adam is required to travel extensively by his employer. He uses his own vehicle for this travel. He purchased his current automobile, a BMW 750i, for $132,000 on January 1, 2019. During the year, he drove the automobile a total of 63,000 kilometers, of which 59,000 were employment related. Operating costs paid for the year totaled $11,300.

In addition to his automobile costs, his other 2019 employment related travel were as follows:

| | |
|---|---:|
| Hotels | $16,000 |
| Food | 7,200 |

His employer provides him with the following allowances for his travel:

| | |
|---|---:|
| Hotels And Food ($700 Per Day) | $21,000 |
| Use Of Personal Automobile ($300 Per Week) | 15,600 |

On a regular annual basis, Adam's employer grants him options to buy the shares in the Company at their trading value on the grant date. During 2019, he exercises options to acquire 1,000 shares at a price of $25 per share. On the exercise date the shares are trading at $28 per share. These shares paid no dividends during the year and Adam still holds the shares on December 31, 2019.

All of the family's other stock investments are owned by Estelle. As a consequence, Adam has no income other than his employment related income and income that results from his charitable donation of real property.

### *Estelle's Investment Information*

When Estelle's father died 6 years ago, he left her with shares in several small business corporations. Prior to 2019, she had the following two dispositions of small business corporation shares:

> **2014** In this year she sold shares in ABC, a qualified small business corporation, for \$500,000. Her adjusted cost base for these shares was \$275,000, resulting in a capital gain of \$225,000. The taxable amount of this gain was eliminated using the lifetime capital gains deduction.
>
> **2016** In this year she sold shares in DEF, a qualified small business corporation, for \$623,000. Her adjusted cost base for these shares was \$216,000, resulting in a capital gain of \$407,000. Once again, the taxable amount of this gain was eliminated using the lifetime capital gains deduction.

Estelle had no other dispositions of capital assets prior to 2019.

All of Estelle's income is derived from her corporate holdings. During 2019, she received a total of \$32,000 in non-eligible dividends from these corporations.

In 2019, she had the following dispositions:

- Shares of GHI, a qualified small business corporation, for \$662,000. Her adjusted cost base for these shares was \$360,000, resulting in a capital gain of \$302,000.
- Shares of JKL, a non-qualified small business corporation, for \$230,000. Her adjusted cost base for these shares was \$250,000, resulting in a capital loss of \$20,000.

For several years, Estelle has been carrying forward a \$15,000 net capital loss. In previous years, she has chosen not to use this carry forward in order to maximize her lifetime capital gains deduction. She would like to use this deduction in 2019, regardless of whether her lifetime capital gains deduction is maximized. Estelle has never had a CNIL balance.

**Required:** Ignore GST/HST/PST considerations in your solution.

A. Determine Adam's Federal Tax Payable for 2019.

B. Determine Estelle's Federal Tax Payable, including alternative minimum tax for 2019.

In both Part A and Part B, indicate any carry forward amounts available at the end of 2019.

# Tax Software Assignment Problems

### *Tax Software Assignment Problem Eleven - 1*

> **This problem is an expansion of the Chapter 4 problem.**
>
> **DISCLAIMER:** All characters appearing in this problem are fictitious. Any resemblance to real persons, living or dead, is purely coincidental.

Mr. Buddy Musician (SIN 527-000-061) was born in Vancouver on August 28, 1951. He has spent most of his working life as a pianist and song writer. He and his family live at 111 WWW Street, Vancouver, B.C. V4H 3W4, phone (604) 111-1111.

Mr. Musician's wife, Natasha (SIN 527-000-129), was born on June 6, 1993. She and Mr. Musician have four children. Each child was born on April 1 of the following years, Linda; 2013, Larry; 2014, Donna; 2015, and Donald; 2016. Natasha's only income during 2018 is \$3,000 from singing engagements.

Buddy and Natasha Musician have two adopted children. Richard (SIN 527-000-285) was born on March 15, 2001 and has income of $2,800 for the year. Due to his accelerated schooling, he started full time attendance at university in September of 2018 at the age of 17. His first semester tuition fee is $3,000 and he requires books with a total cost of $375. These amounts are paid by Mr. Musician.

The other adopted child, Sarah, was born on September 2, 1998, and is in full time attendance at university for all of 2018 (including a four month summer session). Her tuition is $9,600 and she requires textbooks which cost $750. These amounts are also paid by Mr. Musician. Sarah has no income during the year.

Neither Richard nor Sarah will have any income in the next three years. They both have agreed that the maximum tuition amount should be transferred to their father.

Mr. Musician's mother, Eunice, was born on April 10, 1931 and his father, Earl, was born on November 16, 1929. They both live with Mr. Musician and his wife. While his father has some mobility issues, he is not infirm. His mother is legally blind. Eunice Musician had income of $9,500 for the year, while Earl Musician had income of $7,500.

Other information concerning Mr. Musician and his family for 2018 is as follows:

1. Mr. Musician earned $16,500 for work as the house pianist at the Loose Moose Pub. His T4 showed that his employer withheld $500 for income taxes and $293.90 for EI. No CPP was withheld as he has previously filed an election to stop contributing to the CPP.
2. During the year, Mr. Musician made his annual $3,000 donation to Planned Parenthood Of Canada, a registered Canadian charity.
3. Mr. Musician has been married before to Lori Musician (SIN 527-000-319). Lori is 52 years old and lives in Fort Erie, Ontario.
4. Mr. Musician has two additional children who live with their mother, Ms. Dolly Nurse (SIN 527-000-582), in Burnaby, British Columbia. The children are Megan Nurse, aged 12 and Andrew Nurse, aged 14. Neither child has any income during 2018. While Ms. Nurse and Mr. Musician were never married, Mr. Musician acknowledges that he is the father of both children. Although Buddy has provided limited financial aid by paying their dental and medical expenses, the children are not dependent on Buddy for support.
5. Mr. Musician wishes to claim all his medical expenses on a calendar year basis. On December 2, 2018, Mr. Musician paid dental expenses to Canada Wide Dental Clinics for the following individuals:

| | |
|---|---:|
| Himself | $1,200 |
| Natasha (wife) | 700 |
| Richard (adopted son) | 800 |
| Sarah (adopted daughter) | 300 |
| Linda (daughter) | 100 |
| Earl (father) | 1,050 |
| Lori (ex-wife) | 300 |
| Dolly Nurse (mother of two of his children) | 675 |
| Megan Nurse (daughter of Dolly Nurse) | 550 |
| Total | $5,675 |

6. Mr. Musician signed a contract with Fred Nesbitt on January 13, 2018 to do permanent modifications to his house. The contract was for the installation of ramps with sturdy hand railings outside his front and back doors to give his parents easier access to the house and modifications to their bathroom so they would be less likely to fall when using the shower. The contract price was $5,800. As neither of his parents has a severe and prolonged mobility impairment, these expenditures are not eligible medical expenses.
7. Mr. Musician paid four quarterly instalments of $1,000 each (total of $4,000) for 2018, as requested on his Instalment Reminders from the CRA. He paid each instalment on the due

date.

8. Mr. Musician receives $7,121.31 in Old Age Security payments and $5,500 in Canada Pension Plan "retirement benefit" payments over 12 months. There was no tax shown as withheld on his T4A(OAS) or his T4A(P).

9. Mr. Musician builds a state-of-the-art home theatre in a new extension of his home. In order to finance it, he sells stock in his RRSP and withdraws the funds from his RRSP. His T4RSP showed $52,000 in withdrawals from the House of Rock Bank (Box 22) and total tax of $15,600 deducted from these payments.

10. Several of Mr. Musician's songs, including his outstanding hit, "Drop Kick Me Jesus Through The Goal Posts Of Life", have provided him with substantial royalty payments over the years. In 2018, the Never Say Die Record Company paid him $78,000 in royalty payments. No T5 was issued by the Company.

11. In order to ensure the financial security of his family, Mr. Musician decided to return to songwriting in earnest. On November 1, 2018, he rented a small, quiet studio for $700 a month and purchased a Roland electric piano for $7,750 that was delivered there. He does not plan to use the space or piano for personal enjoyment, only for composing.

12. The previous year, on January 2, 2017, Mr. Musician elected not to make any further CPP contributions on his self-employed income.

13. Mr. Musician is required by a court order to pay spousal support of $400 per month to his former spouse, Lori Musician. Mr. Musician made spousal support payments of $4,800 during 2018.

14. Mr. Musician is required by a court order to make child support payments of $350 per month for his two children, Megan and Andrew Nurse. A total of $4,200 was paid during the year.

15. Mr. Musician made contributions to the Federal Liberal Party in the amount of $610 during the year.

16. Mr. Musician made a $5,000 contribution to his TFSA during the year. Thanks to the excellent investing advice of his gardener, the balance in his TFSA account has grown to more than $175,000 by the end of the year.

**Required**: With the objective of minimizing Mr. Musician's Tax Payable, prepare Mr. Musician's 2018 income tax return using the ProFile tax software program assuming Natasha does not file a tax return. List any assumptions you have made, and any notes and tax planning issues you feel should be placed in the file.

### *Tax Software Assignment Problem Eleven - 2*

**This problem is an expansion of the Chapter 4 problem.**

**DISCLAIMER:** All characters appearing in this problem are fictitious. Any resemblance to real persons, living or dead, is purely coincidental.

George Pharmacy is a pharmaceutical salesman who has been very successful at his job in the last few years. Unfortunately, his family life has not been very happy. Three years ago, his only child, Anna, was driving a car that was hit by a drunk driver. She and her husband were killed and their 14 year old son, Kevin, was blinded in the accident. He also suffered extensive injuries to his jaw that have required major and prolonged dental work.

George and his wife, Valerie, adopted Kevin. Valerie quit her part-time job to care for him. She also cares for her mother, Joan Drugstore who lives with them. Joan suffers from dementia, Parkinson's and severe depression. The family doctor has signed a letter stating that she is dependent on George and Valerie because of her impairments. Joan does not meet the residency requirements necessary to qualify for Canadian Old Age Security payments.

Valerie's parents separated two years ago in Scotland after her father, David Drugstore, suffered enormous losses in the stock market. They were forced to sell their home and David moved to Chile. David phones periodically to request that money be deposited in his on-line bank account.

George's brother, Martin, completed an alcohol rehabilitation program after being fired for drinking on the job. He is also living with George and Valerie while he is enrolled as a full time student at Western University. George is paying his tuition and Martin has agreed to transfer any available education related amounts to George. Although Martin plans to file his 2018 tax return, he has not done so yet.

Kevin is taking several undergraduate psychology courses at Western University. After hearing a talk given by an expert blind echolocator, i.e., one who uses sound to locate objects, his goal is to become a researcher at the Brain and Mind Institute and study the use of echolocation.

Other information concerning George for 2018 is given on the following pages.

**Required**: Prepare the 2018 income tax return of George Pharmacy using the ProFile tax software program assuming Valerie does not file a tax return. List any assumptions you have made, and any notes and tax planning issues you feel should be placed in the file. Ignore HST implications in your solution by assuming that George does not qualify for the GST/HST rebate.

| Personal Information | Taxpayer |
|---|---|
| Title | Mr. |
| First Name | George |
| Last Name | Pharmacy |
| SIN | 527-000-509 |
| Date of birth (Y/M/D) | 1954-07-02 |
| Marital Status | Married |
| Canadian citizen? | Yes |
| Provide information to Elections Canada? | Yes |
| Own foreign property of more than $100,000 Canadian? | No |

| Taxpayer's Address |
|---|
| 123 ZZZ Street, London, Ontario N0Z 0Z0 |
| Phone number (519) 111-1111 |

| Family Members | Spouse | Child | Mother-In-Law |
|---|---|---|---|
| First Name | Valerie | Kevin | Joan |
| Last Name | Pharmacy | Pharmacy | Drugstore |
| SIN | 527-000-483 | 527-000-517 | None |
| Date of birth (Y/M/D) | 1953-12-30 | 2002-10-17 | 1933-02-24 |
| Net income | $6,520 in CPP | Nil | $500 |

| Family Members | Father-In-Law | Brother |
|---|---|---|
| First Name | David | Martin |
| Last Name | Drugstore | Pharmacy |
| SIN | None | 527-000-533 |
| Date of birth (Y/M/D) | 1934-01-12 | 1971-06-02 |
| Net income | Nil | $8,300 |

During September, David was arrested in Chile. Valerie had to spend three weeks in Chile and pay $2,000 in bribes before she could get him released from jail. George had to pay Nannies On Call $3,500 for in-home help to take care of Kevin while she was gone.

| T2202A - (Martin) | Box | Amount |
|---|---|---|
| Tuition fees - for Martin Pharmacy (brother) | A | 8,000 |
| Number of months in school - part-time | B | 0 |
| Number of months in school - full-time | C | 8 |

| T2202A - (Kevin) | Box | Amount |
|---|---|---|
| Tuition fees - for Kevin | A | 3,600 |
| Number of months in school - part-time | B | 8 |
| Number of months in school - full-time | C | 0 |

| Donor | Charitable Donation Receipts | Am't |
|---|---|---|
| Valerie | Mothers Against Drunk Drivers (MADD) | 1,000 |
| George | Canadian Institute For The Blind (CNIB) | 3,000 |

| T4 | Box | Amount |
|---|---|---|
| Issuer - Mega Pharma Inc. | | |
| Employment income | 14 | 378,000.00 |
| Employee's CPP contributions | 16 | 2,593.80 |
| Employee's EI premiums | 18 | 858.22 |
| Income tax deducted | 22 | 114,000.00 |
| Employment commissions | 42 | 82,000.00 |
| Charitable donations | 46 | 400.00 |

During 2018, Mega reimbursed George $3,788 for meals and entertainment with clients, $2,268 for hotels and $4,925 for airline tickets.

In addition to George's salary, he also earns commissions. His employer requires him to have an office in his home and has signed the form T2200 each year to this effect.

During 2018, George purchased a new computer and software that will be used solely in his home office for employment related uses. The computer cost $3,600 and the various software programs cost $1,250.

| House Costs | |
|---|---|
| Area of home used for home office (square feet) | 650 |
| Total area of home (square feet) | 5,000 |
| Telephone line including high speed internet connection | 620 |
| Hydro | 3,200 |
| Insurance - House | 4,000 |
| Maintenance and repairs | 3,800 |
| Mortgage interest | 6,200 |
| Mortgage life insurance premiums | 400 |
| Property taxes | 6,700 |

| (Y/M/D) | Patient | Medical Expenses | Description | Am't |
|---|---|---|---|---|
| 2018-12-31 | George | Johnson Inc. | Out of Canada insurance | 731.00 |
| 2018-08-31 | George | Dr. Smith | Dental fees | 155.40 |
| 2018-09-19 | George | Optician | Prescription glasses | 109.00 |
| 2018-11-07 | Valerie | Pharmacy | Prescription | 66.84 |
| 2018-06-07 | Joan | Dr. Wong | Psychiatric counseling | 2,050.00 |
| 2018-03-22 | David | Tropical Disease Centre | Prescription | 390.00 |
| 2018-12-20 | Martin | Dr. Walker | Group therapy | 6,000.00 |
| 2018-10-01 | Kevin | Dr. Takarabe | Orthodontics and Dental | 30,000.00 |

George paid $800 for the care and feeding of Kevin's seeing eye dog, Isis, during 2018.

On October 1, 2018, George purchased a new computer and software that will be used solely in his home office for employment related uses. The computer cost $3,600 and the various software programs cost $1,250.

At the beginning of 2018, George had a net capital loss carry forward of $10,500 from the sale of shares in 2017. He had not disposed of any capital assets prior to 2017.

| Asset Dispositions | Asset 1 | Asset 2 | Asset 3 |
|---|---|---|---|
| Description | Molson Inc. shares | Imperial Oil shares | Sailboat |
| Number of units | 150 | 387 | N/A |
| Year of acquisition | 2015 | 2016 | 2016 |
| Date of disposition | February 14 | June 6 | October 1 |
| Proceeds of disposition | 37,000 | 9,600 | 74,000 |
| Adjusted cost base | 27,600 | 12,100 | 72,000 |
| Outlays and expenses | 35 | 29 | N/A |

| Asset Dispositions | Asset 4 | Asset 5 | Asset 6 |
|---|---|---|---|
| Description | Motorcycle | Painting | Coin collection |
| Year of acquisition | 2018 | 2011 | 2015 |
| Date of disposition | November 17 | August 28 | March 24 |
| Proceeds of disposition | 14,000 | 1,100 | 700 |
| Adjusted cost base | 21,000 | 450 | 1,800 |
| Outlays and expenses | N/A | N/A | N/A |

| Real Estate Rental - Commercial Property | Amount |
|---|---|
| Address - 888 YYZ Drive, Toronto, Ontario M0M 0M0 | |
| Year of purchase | 2014 |
| Gross rents | 16,000 |
| Property taxes | 5,128 |
| Insurance | 1,890 |
| Interest on mortgage | 3,175 |
| Payment on principal | 2,200 |
| Furnace repairs | 550 |
| Maintenance contract | 3,469 |
| Building purchased for $120,100 - UCC beginning of year | 107,441 |
| Fixtures purchased for $8,500 - UCC beginning of year | 4,651 |

The building and fixtures were purchased on August 28, 2014. At the time the building and fixtures were being used as a drugstore and Mr. Pharmacy has retained the same tenant.

George knows he should have been contributing to various savings plans over the years, but his increasing number of needy dependants required he spend all of his take home pay to support them and he has contributed to none. It was only in 2018 that his compensation had increased enough so that he had sufficient funds to consider savings plans.

His daughter had made contributions totalling more than $10,000 to an RESP for Kevin prior to her death, but George has made no RESP contributions to the plan since then.

### Tax Software Assignment Problem Eleven - 3

**This problem is an expansion of the Chapter 4 problem.**

**DISCLAIMER:** All characters appearing in all versions of this problem are fictitious. Any resemblance to real persons, living or dead, is purely coincidental.

#### Information Related To Chapter 4 Material

Seymour Career and Mary Career are your tax clients. They have been married for two years. Mary has progressed quickly in MoreCorp, the large, publicly traded firm she is working for due to her strong tax and accounting background. Her firm has an excellent health and dental plan that reimburses 100 percent of all medical and dental expenses.

| Personal Information | Taxpayer | Spouse |
|---|---|---|
| Title | Ms. | Mr. |
| First Name | Mary | Seymour |
| Last Name | Career | Career |
| SIN | 527-000-129 | 527-000-079 |
| Date of birth (Y/M/D) | 1980-12-08 | 1959-01-29 |
| Marital status | Married | Married |
| Canadian citizen? | Yes | Yes |
| Provide information to Elections Canada? | Yes | Yes |
| Own foreign property of more than $100,000 Cdn? | No | No |

| Taxpayer's Address |
|---|
| 123 ABC Street, Saint John, N.B. E0E 0E0 |
| Phone number (506) 111-1111 |
| Spouse's address same as taxpayer? Yes |

| Dependant | Child |
|---|---|
| First Name | William |
| Last Name | Career |
| SIN | 527-000-319 |
| Date of Birth (Y/M/D) | 2011-02-24 |
| Net Income | Nil |

| T4 - Mary | Box | Amount |
|---|---|---|
| Issuer - MoreCorp | | |
| Employment Income | 14 | 152,866.08 |
| Employee's CPP Contributions | 16 | 2,593.80 |
| Employee's EI Premiums | 18 | 858.22 |
| RPP Contributions | 20 | Nil |
| Income Tax Deducted | 22 | 48,665.11 |
| Charitable Donations | 46 | 1,000.00 |

| Donor | Charitable Donation Receipts | Amount |
|---|---|---|
| Seymour | Canadian Cancer Foundation | 500 |
| Seymour | Salvation Army | 250 |

### *Information Related To Chapter 6 Material*

**Tax Software Note** To create a return for Seymour that is coupled to Mary's, hit the F5 key with Mary's return open.

Seymour earns business income writing and editing instruction manuals on a contract basis. He has six different clients and operates under the business name Crystal Clear Communications from an office in their home. One of his clients issues him a T4A for the work that he has done for them.

During the year, Seymour is a part time student at Dalhousie University for 3 months. He is enrolled in the musicology program.

| Business or Professional Income - Seymour | |
|---|---|
| Revenues without T4A | 41,603.17 |
| T4A's issued (see T4A information) | 20,000.00 |
| Membership dues - Business Writers Association | 231.00 |
| Business insurance | 126.16 |
| Bank service charges | 156.20 |
| Cell phone air time | 485.27 |
| Postage and courier charges | 110.00 |
| Supplies | 2,982.17 |
| Separate business phone line charge | 577.86 |
| Fees for accounting and tax advice | 500.00 |
| Air fare (business travel) | 526.97 |
| Hotels (business travel) | 1,240.91 |
| Meals when traveling on business | 607.14 |
| Meals and drinks when entertaining clients | 887.12 |
| UCC of furniture - beginning of year | 2,254.94 |
| UCC of computer application software - beginning of year | 219.15 |
| UCC of computer hardware (Class 50) - beginning of year | 426.00 |
| Application software purchased May 12, 2018 | 525.00 |
| Laptop computer purchased May 12, 2018 | 2,048.00 |

The mortgagee of Seymour's house, the Royal Bank, does not require life insurance.

| House Costs | |
|---|---|
| Area of home used for business (square feet) | 160 |
| Total area of home (square feet) | 1,500 |
| Gas for heating | 1,712.86 |
| Hydro | 1,641.18 |
| Insurance - house | 757.55 |
| Snow plowing contract | 440.00 |
| Installation of new gas furnace | 3,675.00 |
| Painting of house interior | 2,548.05 |
| Mortgage interest paid to Royal Bank | 8,456.22 |
| Mortgage life insurance premiums | 375.00 |
| Mortgage principal paid | 1,279.58 |
| Property taxes | 2,533.01 |
| Interest on late property taxes | 122.52 |

**Tax Software Note** As the problem requires that you ignore GST/HST implications, enter all motor vehicle expenses as non-eligible for GST or HST.

| Car Costs - Seymour | |
|---|---|
| Description - Subaru, cost = $35,000, bought 2015-02-15 | |
| January 1 odometer | 89,726 |
| December 31 odometer | 124,701 |
| Business kilometers driven | 8,412 |
| Parking | 321.71 |
| Gas | 2,582.12 |
| Maintenance and repairs | 458.63 |
| Car insurance | 779.00 |
| Licence and registration fees | 49.87 |
| Interest on 4 year car loan granted on purchase date | 597.89 |
| UCC of Class 10.1 - beginning of year | 15,470.00 |

| T2202A - Seymour | Box | Amount |
|---|---|---|
| Tuition fees | A | 2,200 |
| Number of months in school - part-time | B | 3 |
| Number of months in school - full-time | C | 0 |

| T4A - Seymour | Box | Amount |
|---|---|---|
| Issuer - 3065 Canada Inc. | | |
| Fee For Services (Professional) | 48 | 20,000.00 |

### *Information Related To Chapter 7 Material*

Seymour was previously married and has a 19 year old daughter from the previous marriage. As part of the property settlement, he received the house that he and his family had lived in. Since Mary already owned a much nicer home, he moved in with her when they were married in 2016 and rented out the property.

Seymour believed that in June he had paid an income tax instalment of $2,400 for 2018, but could find no record of it. You call the CRA and find that the June payment was towards his 2017 tax liability. Seymour had tax owing of more than $10,000 for 2017 and has not completely paid off the liability yet. He has paid no instalments for 2018.

Mary also paid no instalments for 2018. She has received tax refunds in the last two years.

During 2016, one of his clients convinced Seymour to take out a demand loan to purchase shares in the public company, EEE Art Films Ltd. for $37,000. Later that year, the company's president was indicted for fraud. In 2017, Seymour sold his shares for $2,000 and used the proceeds to pay down his demand loan. During 2018, Seymour did not have sufficient funds to pay off the demand loan, but managed to reduce the principal by $10,000.

The interest and penalties paid by Seymour during 2018 were as follows:

| | |
|---|---|
| Interest on credit cards for business expenses | $ 627.27 |
| Interest on loan to buy laptop and software | 104.24 |
| Interest on loan to make 2017 RRSP contribution | 162.15 |
| Interest on loan to purchase EEE Art Films securities | 1,372.52 |
| Interest on late payment of 2017 income tax | 233.72 |
| Interest on insufficient tax instalments for 2017 | 52.81 |
| Interest on late GST/HST payments | 212.82 |
| Penalty for late filing of 2017 tax return | 303.92 |
| Total | $3,069.45 |

Mary has invested in the stock market over the years and has done well. Seymour holds no securities outside of his RRSP during 2018. Mary has received her T3 and T5 information slips from her stockbroker and bank. The interest from the TD Bank is from a joint chequing account in the name of both Mary and Seymour.

**Tax Software Note** By inputting the joint T5 on Mary's return, the T5 information will appear on Seymour's Statement Of Investment Income (Schedule 4), but not on his T5 slip screen.

| T5 | Box | Slip 1 | Slip 2 |
|---|---|---|---|
| Issuer | | Power Corp. | TD Bank |
| Recipient (Input both on Mary's return) | | Mary | Joint 50% each |
| Actual amount of eligible dividends | 24 | 950.00 | |
| Taxable amount of eligible dividends | 25 | 1,311.00 | |
| Interest from Canadian sources | 13 | | 236.11 |

| T3 | Box | Amount |
|---|---|---|
| Issuer - TD Asset Management | | |
| Recipient - Mary Career | | |
| Foreign country - United States | | |
| Foreign non-business income (Canadian dollars) | 25 | 1,553.10 |
| Foreign income tax paid - investment (Canadian dollars) | 34 | 37.00 |
| Other income - investment | 26 | 214.50 |
| Actual amount of eligible dividends | 49 | 346.00 |
| Taxable amount of eligible dividends | 50 | 477.48 |

| Real Estate Rental - Seymour | Amount |
|---|---|
| Address - 555 LLL Street, Moncton, NB, E0E 0E0 | |
| Gross rents | 12,000.00 |
| Property taxes | 3,610.00 |
| Insurance | 650.00 |
| Interest on mortgage | 4,207.25 |
| Payment on principal | 1,511.92 |
| Wiring and furnace repairs | 2,282.71 |
| Snow removal and landscaping annual contract | 1,070.00 |
| Building purchased May 1, 2005 for $150,000 - UCC beginning of year | 150,000.00 |
| Appliances purchased June 6, 2016 for $1,700 - UCC beginning of year | 1,350.00 |

### *Information Related To Chapter 8 Material*

When Mary's grandmother died in 2016, she inherited some pieces of jewelry, as well as a dining room set and a chandelier. Since the jewelry is not suited to Mary's relaxed style of dress, she sold some pieces during 2018. She sold the dining room set and chandelier to two colleagues from work.

Mary has purchased Extreme Wi-Fi Technologies stock over the years. Her transactions in this stock are as follows:

| Acquisition Date | Shares Purchased (Sold) | Cost Per Share | Total Cost |
|---|---|---|---|
| April 1, 2016 | 1,500 | $ 2 | $ 3,000 |
| October 1, 2016 | 2,000 | 12 | 24,000 |
| April 1, 2017 | (1,000) | ? | |
| June 1, 2017 | 400 | 25 | 10,000 |
| January 6, 2018 | ( 800) | ? | |
| February 1, 2018 | 800 | 20 | 16,000 |
| March 14, 2018 | ( 600) | ? | |

Mary Career provides you with the following information about her sales of securities and other items.

| Asset Dispositions | Disposition 1 | Disposition 2 | Disposition 3 |
|---|---|---|---|
| (All owned by Mary) Description | Extreme Wi-Fi Technologies | Extreme Wi-Fi Technologies | Fidelity Small Cap Fund |
| Number of units | 800 | 600 | 258.92 |
| Year of acquisition | 2016 | 2016 | 2016 |
| Date of disposition | January 6 | March 14 | February 17 |
| Proceeds of disposition | 11,806 | 13,465 | 2,982.31 |
| Adjusted cost base | ? | ? | 5,300.33 |
| Outlays and expenses | 29 | 29 | Nil |

| Asset Dispositions | Disposition 4 | Disposition 5 | Disposition 6 |
|---|---|---|---|
| Description | Diamond Pendant | Gold Ring | Pearl Brooch |
| Year of acquisition | 2016 | 2016 | 2016 |
| Date of disposition | July 20 | July 20 | July 20 |
| Proceeds of disposition | 4,000 | 750 | 1,300 |
| FMV at grandmother's death | 5,800 | 600 | 850 |

| Asset Dispositions | Disposition 7 | Disposition 8 |
|---|---|---|
| Description | Dining room set | Crystal Chandelier |
| Year of acquisition | 2016 | 2016 |
| Date of disposition | July 20 | July 20 |
| Proceeds of disposition | 200 | 1,500 |
| FMV at grandmother's death | 3,000 | 800 |

### *Information Related To Chapter 9 Material*

Seymour has made all of the required payments to his ex-wife Monica DeWitch (SIN 527-000-186) in 2018. In your files, you have noted that his 2015 divorce agreement requires Seymour to pay spousal support to his ex-wife of $200 per month. He also pays her child support of $250 per month for his 19 year old daughter, Faith.

Mary tells you that her parents have established an RESP for William in 2018, and are the sole contributors. They have contributed $300 in lieu of Christmas and birthday presents.

Mary has learned that Seymour's mother purchased a Guaranteed Investment Certificate (GIC) in William's name in 2018. The GIC paid interest of $120 in 2018 which Seymour had spent without advising her. She expects a T5 to be issued in William's name.

Mary registered William for art classes at the Da Vinci Institute on Saturdays. She provides you with the following receipts:

| Child | Child Related Expenses (Organization or Name and SIN) | No. of weeks | Amount |
|---|---|---|---|
| William | No Worries Childcare (after school and summer) | | 3,100 |
| William | Da Vinci Institute | 16 | 1,000 |

On December 23, 2018, you receive a call from Mary Career with the terrible news that Seymour has just suffered a massive heart attack and died. Mary, his executor, inherits all of his assets except for the rental property and appliances in Moncton which he has left to his daughter, Faith. Assume the transfer of the property and appliances takes place in 2018.

As Seymour was thinking of selling the property, he had it appraised in early December. The appraisal valued the land at $60,000, the building at $180,000, and the appliances at $700. Seymour had purchased the property on May 1, 2005 for $195,000 (land of $45,000 and building of $150,000) and lived in it until his marriage to Mary in 2016.

**Tax Software Notes** On Seymour's "Info" page, input his date of death (under his birth date). Answer No to the question "Is this an Early Filed ...?". On Mary's return, check that her marital status has been changed to widowed and the date of change is included.

Answer Yes on the Info page on Seymour's return to the question "Did you dispose of a property ...?"

Complete the T2091, Designation Of Property As A Principal Residence for Seymour's Moncton property and S3PrincipalResidenceDetail.

### *Information Related To Chapter 10 Material*

On January 10, 2019, you receive a phone call from Mary Career. She has just received a T4RSP in the mail which shows that Seymour had withdrawn virtually all the funds from his RRSP without her knowledge. She knows this could substantially increase Seymour's tax liability and is very concerned. At the moment, she cannot find any trace of the funds that were withdrawn.

Her stockbroker has told her that a spousal contribution can be made to her RRSP to utilize Seymour's unused contribution room. She would like you to calculate the maximum RRSP contribution that can be deducted on Seymour's return so that she can contribute that amount to her RRSP and have the RRSP receipt issued with Seymour's name as the contributor.

She would also like you to calculate the maximum RRSP contribution that can be deducted on her own return for 2018 and 2019. Since Mary has received more than $1 million in life insurance benefits, she will make the maximum RRSP contributions for Seymour and herself that you have calculated immediately (before the end of February, 2019).

She provides you with the following T4RSP and RRSP receipt for the contributions that she has already made, as well as information related to her and Seymour's RRSP limits.

| RRSP information - Mary | (Y/M/D) | Amount |
|---|---|---|
| Issuer of receipt - TD Asset Management | 2018-12-10 | 5,400 |
| Issuer of receipt - TD Asset Management | 2019-01-05 | 16,800 |
| Contributions made prior to 2019/03/02 and not deducted | | Nil |
| Unused deduction room at the end of 2017 | | 14,091 |
| Earned income for 2017 | | 180,000 |

| T4RSP - Seymour | Box | Amount |
|---|---|---|
| Issuer of receipt - Royal Bank | | |
| Withdrawal payments (in amounts of < $5,000 each) | 22 | 126,000 |
| Income tax deducted | 30 | 12,600 |

| RRSP information - Seymour | (Y/M/D) | Amount |
|---|---|---|
| Issuer of receipt - TD Asset Management | | Maximum ? |
| Contributions made prior to 2019/03/02 and not deducted | | Nil |
| Unused deduction room at the end of 2017 | | 19,762 |
| Earned income for 2017 | | 45,000 |

### *Information Related To Chapter 11 Material*

In checking Seymour's file, you find he has a net capital loss carry forward of $17,500 [(1/2)($35,000)] from the sale of his EEE Art Films Ltd shares in 2017. Mary has informed you that she has made all of the RRSP contributions as you had calculated.

On February 14, 2019, you receive a call from a very upset Mary Career. She has just received an amended T4. The original T4 had not included information on the stock options in her employer, MoreCorp (a public company), that she had exercised.

Mary had options to purchase 500 shares of MoreCorp at $42 per share. When she received the options, the shares were trading at $40 per share. On December 20, 2018, when the shares were trading at $125 per share, she exercised her options for 200 shares. She left verbal instructions for MoreCorp to immediately donate all of the shares to Tax Behind Bars, a Canadian registered charity whose volunteers provide extensive tax education to inmates in prisons across Canada.

Unfortunately for Mary, the employee she had given the donation instructions to was fired for falsifying her credentials so the donation was not done and she did not receive a 2018 charitable donation receipt.

| Amended T4 - Mary | Box | Original Am't | Amended Am't |
|---|---|---|---|
| Issuer - MoreCorp | | | |
| Employment income | 14 | 152,866.08 | 169,466.08 |
| Employee's CPP contributions | 16 | 2,593.80 | 2,593.80 |
| Employee's EI premiums | 18 | 858.22 | 858.22 |
| RPP contributions | 20 | Nil | Nil |
| Income tax deducted | 22 | 48,665.11 | 48,665.11 |
| Stock option deduction 110(1)(d) | 39 | Nil | 8,300.00 |
| Charitable donations | 46 | 1,000.00 | 1,000.00 |

**Required**: With the objective of minimizing the tax liability for the family, prepare Mary's 2018 income tax return and Seymour's final 2018 return. List any assumptions you have made and provide any explanatory notes and tax planning issues you feel should be placed in the files. Include in your solution Mary's maximum RRSP deduction for 2019.

# CHAPTER 12

# Taxable Income And Tax Payable For Corporations

## Note On Recent Developments

### Small Business Deduction Rate

For many years, the small business deduction reduced the federal tax rate on the qualifying income of Canadian Controlled Private Companies (CCPCs) to 11 percent. In 2016, the deduction was increased by one-half percent, reducing the federal rate to 10.5 percent, with further rate reductions scheduled for 2017 and 2018.

However, the government concluded that they could not afford the reductions scheduled for 2017 and 2018, resulting in a cancellation of these changes. This resulted in the relevant rate remaining at 10.5 percent for 2017 and, as originally proposed, for subsequent years.

However, for 2018 and 2019, the government has reinstated the reductions in the federal rate that were proposed in 2016. Increases in the deduction resulted in a 2018 rate of 10 percent and a 2019 rate of 9 percent on eligible taxable income.

### Tax Planning By Private Corporations

#### *Problems*

These reductions in the federal rate on the qualifying income of CCPCs reflected the government's policy of encouraging small business. This was based on the view that such businesses are very helpful to the Canadian economy in that they encouraged both additional investment in capital assets and the employment of Canadian individuals.

While providing these reduced rates to CCPCs, the government also recognized that these very favourable rates were being abused by wealthy Canadians to both reduce and defer taxes in situations that were not helpful to the Canadian economy. The two basic problems identified were:

- The sprinkling of dividend and other types of income to related individuals that were in low tax brackets, significantly reducing the amount of taxes that were paid on a given income stream.
- The accumulation of passive investments within the corporation with income that benefited from being taxed at the low rates applicable to the qualifying income of CCPCs. This

resulted in both tax avoidance and tax deferral.

Based on this belief, the government introduced measures to correct these abuses. We will provide an overview of these measures in this note on recent developments.

## Income Sprinkling

As discussed briefly in Chapter 1, income splitting is one of the most powerful weapons in a tax planner's arsenal. While the government finds the use of income splitting to be appropriate in certain situations (e.g., spousal RRSPs and pension income splitting), it believes that abusive use of income sprinkling creates an unfair element in our taxation system. This reflects the fact that the more sophisticated forms of income splitting are only available to wealthy Canadians.

The government's approach to dealing with this problem was the 2018 expansion of the application of the Tax On Split Income (TOSI). As this tax is related directly to individuals and involves business entities other than corporations, the changes in the TOSI were covered in Chapter 11. We will not provide additional direct coverage of the TOSI in this or subsequent Chapters. However, we will refer to this tax as required in material that deals with other types of taxable entities (corporations and trusts).

## Private Companies Holding Passive Investments

It is not uncommon for a private corporation to be sufficiently successful that it is producing income that is larger than the current consumption needs of the owners, in some cases significantly larger. Given the desire to avoid taxation at the individual level, such owners will often invest this excess in passive investments to be held in the corporation. There are, in fact, many private companies that are holding millions of dollars in passive investments that have nothing to do with the corporation's business.

To the extent that passive investments are acquired with after-tax funds to which full corporate rates have been applied, there is no real issue. As we shall find in Chapter 13, income on such investments is taxed at very high corporate rates, with a portion of this tax refunded when taxable dividends are paid to, and taxed in the hands of, the shareholders of the corporation.

However, a problem arises when such investments are acquired with after tax funds that have only been subject to the rates applicable to income that qualifies for the small business deduction. A simple example will serve to illustrate the issue.

**EXAMPLE** Sam and Ira Johnston are brothers, both of whom have employment income in excess of $250,000. Any additional income that they receive personally will be taxed at a combined federal/provincial rate of 52 percent.

They both have a business which produces an additional $200,000 in business income, none of which is required to meet their families' financial needs. Sam's business is a proprietorship while Ira's business is operated inside a private company. On its active business income, Ira's private company is taxed at a combined federal/provincial rate of 15 percent.

**ANALYSIS** The amounts of after tax business income retained by the two brothers would be as follows:

| | Sam | Ira |
|---|---|---|
| Before Tax Business Income | $200,000 | $200,000 |
| Tax Payable On Additional Income | | |
| Sam At 52 Percent | ( 104,000) | |
| Ira At 15 Percent | | ( 30,000) |
| After Tax Retention | $ 96,000 | $170,000 |

Ira's corporation has $74,000 ($170,000 - $96,000) more in funds available for acquiring passive investments as compared to Sam's proprietorship. While subsequent earnings on Ira's investments will be taxed at corporate rates similar to those applicable to Sam, over time Ira will accumulate a much larger investment portfolio.

There are, in fact, many cases where the additional investments have accumulated to millions of dollars. Not surprisingly, the government views this as an abuse of the favourable rates that are available to small businesses.

Given the variety of situations where small businesses are holding passive investments (e.g., they may be held to cover seasonal increases in costs), finding a solution to this problem has been difficult. While a number of approaches were considered, the final solution that was provided with the 2018 federal budget involved two components.

**Small Business Deduction Limit Grind** A grind is a programmed reduction in some specified tax variable. For a number of years, the annual limit on income eligible for the small business deduction ($500,000) has been reduced by the amount of a CCPC's Taxable Capital Employed in Canada that is in excess of $10 million. For 2019, the limit will be ground down by the greater of this reduction and a new grind based on ADJUSTED Aggregate Investment Income in excess of $50,000.

While the taxation of corporate investment income is not covered until Chapter 13, this rather simple component of the solution to the passive investment income problem will be covered in this Chapter. This reflects the fact that it must be considered in conjunction with the Taxable Capital Employed In Canada grind which is covered in this chapter.

**Division Of The Refundable Dividend Tax On Hand Account (RDTOH)** This second component of the solution to the passive investment income problem is much more complex. Chapter 13, which deals with the taxation of corporate investment income, introduces the procedures associated with taxes that can be refunded when certain types of corporations pay dividends to their shareholders. The RDTOH account is used to track the availability of dividend refunds and, prior to 2019, all amounts in this account could be used to claim a dividend refund on the more favourably taxed eligible dividends (see Chapter 7). For 2019 and subsequent years, this account is divided into two components with a view to restricting the amount of the dividend refund that can be claimed on the payment of eligible dividends.

Both of these new rules are effective for taxation years beginning after 2018.

# Computation Of Net Income

12-1. The day-to-day records of most corporations are kept in terms of accounting procedures and policies that are normally referred to as Generally Accepted Accounting Principles (GAAP). As noted in Chapter 6, Business Income, many of the rules for computing business income under the *Income Tax Act* are identical to those used under GAAP. However, there are a number of differences that are specifically provided for and, as a result, the first step in the computation of Taxable Income for a corporation is to convert accounting Net Income as determined under GAAP into Net Income For Tax Purposes. Only then can we move from Division B's Net Income For Tax Purposes to Division C's Taxable Income.

12-2. In making this conversion, there are many adjustments that could be required in particular circumstances. Some adjustments are necessary because of different allocation patterns that result in timing differences between accounting and tax income. Examples of this would be differences between accounting amortization and CCA, as well as alternative approaches to the determination of pension cost deductions. Other adjustments involve permanent differences between accounting and tax amounts. An example of this type of difference would be the non-taxable one-half of capital gains. While accounting records include 100 percent of such gains, one-half of such gains will never be included in Net Income For Tax Purposes.

12-3. A reconciliation between accounting Net Income and Net Income For Tax Purposes is a required part of the corporate tax return. The form that the CRA provides for this reconciliation is designated Schedule 1. The most common adjustments from this Schedule are listed in Figure 6-1 in Chapter 6 and that list has been duplicated as Figure 12-1 (following page).

**Figure 12 - 1**
**Conversion Of Accounting Net Income To Net Income For Tax Purposes**

**Additions To Accounting Income:**
- Income tax expense
- Amortization, depreciation, and depletion of tangible and intangible assets (accounting amounts)
- Recapture of CCA
- Tax reserves deducted in the prior year
- Losses on the disposition of capital assets (accounting amounts)
- Pension expense (accounting amounts)
- Scientific research expenditures (accounting amounts)
- Warranty expense (accounting amounts)
- Amortization of discount on long-term debt issued (see discussion in Chapter 7)
- Foreign tax paid (accounting amounts)
- Excess of taxable capital gains over allowable capital losses
- Interest and penalties on income tax assessments
- Non-deductible automobile costs
- 50 percent of business meals and entertainment expenses
- Club dues and cost of recreational facilities
- Non-deductible reserves (accounting amounts)
- Charitable donations
- Asset write-downs including impairment losses on intangibles
- Fines, penalties, and illegal payments

**Deductions From Accounting Income:**
- Capital cost allowances (CCA)
- Incorporation costs (First $3,000)
- Terminal losses
- Tax reserves claimed for the current year
- Gains on the disposition of capital assets (accounting amounts)
- Pension funding contributions
- Deductible scientific research expenditures
- Deductible warranty expenditures
- Amortization of premium on long-term debt issued
- Foreign non-business tax deduction [ITA 20 (12)]
- Allowable business investment losses
- Landscaping costs

12-4. Chapter 6 on business income provided a detailed discussion of the conversion of Net Income for accounting purposes into Net Income For Tax Purposes. As that discussion is equally applicable to both corporations and unincorporated businesses, it will not be repeated here. However, if you are not familiar with the material in Chapter 6, we suggest that you review it before proceeding with these Chapters on corporate taxation. Exercise Twelve-1 provides a fairly simple illustration of how this reconciliation works.

## Exercise Twelve - 1

**Subject:** Schedule 1 Reconciliation

Available information for the S1 Company for the year includes the following:

1. A capital asset was sold for $48,300. It had a cost of $120,700 and a net book value of $53,900. It was the last asset in its CCA class and the UCC balance in this class was $34,600 before the disposition. There were no other additions or dispositions during the year.
2. During the year, the Company acquired goodwill at a cost of $180,000. Since there was no impairment of the goodwill during the year, no write-down was required for accounting purposes.

3. During the year, the Company expensed charitable donations of $15,000.
4. Premium amortization on the Company's bonds payable was $4,500 for the year.

You have been asked to prepare a Schedule 1 reconciliation of accounting Net Income and Net Income For Tax Purposes. Determine the addition and/or deduction that would be made in Schedule 1 for each of the preceding items.

**SOLUTION available in print and online Study Guide.**

**We suggest you work Self Study Problem Twelve-1 at this point.**

# Computation Of Taxable Income

## Deductions Available To Corporations

12-5. The reconciliation schedule illustrated in Figure 12-1 is used to establish a corporation's Net Income For Tax Purposes. When this task is completed, certain specified items are deducted from the resulting Net Income For Tax Purposes figure in order to arrive at Taxable Income. These deductions are specified in Division C of the *Income Tax Act* and the relevant items for individuals were given detailed coverage in Chapters 4 and 11. However, there are significant differences in the Division C deductions available to individuals and those available to corporations.

12-6. With respect to the Division C items that are available to individuals, the following are not available to corporations:

- employee stock option deduction
- deduction for payments (social assistance and workers' compensation benefits)
- lump-sum payments
- lifetime capital gains deduction
- northern residents deductions

12-7. A further significant difference relates to two items that, with respect to individuals, serve as a base for credits against Tax Payable. While these items are not available as a base for credits against corporate Tax Payable, they are available as deductions in the calculation of corporate Taxable Income. These items are:

> **Charitable Donations** Unlike the situation for individuals where charitable donations are the basis for a tax credit, corporations deduct charitable donations from Net Income For Tax Purposes in the determination of Taxable Income. While corporations have a deduction rather than a tax credit, the rules for determining which donations can be deducted by a corporation are essentially the same as the rules for determining which donations qualify for the tax credit for individuals. Further, corporations are subject to the same limits that apply to individuals, with respect to the amount that can be deducted in the current taxation year. The five year carry forward provision is also applicable to corporations. These matters are given detailed consideration in Chapters 4 and 11 and will not be repeated here.
>
> **Dividends** As noted in previous Chapters, individuals must gross up dividends received from taxable Canadian corporations by 15 percent for non-eligible dividends or 38 percent for eligible dividends. This is accompanied by a federal dividend tax credit equal to either 9/13 of the gross up or 6/11 of the gross up. There is no corresponding gross up or tax credit with respect to dividends received by a corporation. However, a corporation is permitted to deduct the full amount of such dividends in the calculation of Taxable Income. Note that, while this deduction removes dividends from Taxable Income and the Tax Payable calculation, they must be included in determining Net Income For Tax Purposes.

12-8. In addition to the two preceding deductions, corporations are allowed to deduct loss carry overs from previous or subsequent years in the calculation of Taxable Income. Other

**Figure 12 - 2**
**Conversion Of Corporate Net Income For Tax Purposes To Taxable Income**

**Net Income (Loss) For Tax Purposes**

**Less:**
- Charitable donations (Limited to 75 percent of Net Income For Tax Purposes with a five year carry forward of unused amounts)
- Dividends received from taxable Canadian corporations
- Loss carry overs from subsequent or prior taxation years

**Equals Taxable Income (Loss)**

than in situations where a corporation has been the subject of an acquisition of control (see Chapter 14), the rules related to the deduction of loss carry overs by corporations are basically the same as those applicable to individuals. These general rules are covered in Chapter 11 and will not be repeated here.

12-9. The calculation of corporate Taxable Income is outlined in Figure 12-2.

## Dividends From Other Corporations

### *Deduction From Taxable Income*

12-10. ITA 112(1) permits a corporation to deduct, in the determination of Taxable Income, dividends that are received from taxable Canadian corporations.

12-11. The reason for this deduction is fairly obvious. If taxes were levied on transfers of dividends between companies, it could result in taxes being repeatedly assessed on the same diminishing stream of income. That is, the paying corporation would be taxed on the income that provided the dividend and if, in addition, the receiving corporation had to include the amount received in its Taxable Income, double taxation of the same income would result. In more complex, multi-level corporate structures, this could extend to triple, quadruple, or even greater applications of tax to a single stream of income.

**EXAMPLE** Mr. X owns 100 percent of the common shares of Company X, and Company X owns 100 percent of the common shares of Company Y. Both Companies pay out all of their after tax income as dividends. Company Y has income of $1,000 for the year and Company X has no income other than dividends from Company Y. Assume both Company X and Company Y are subject to a combined federal/provincial tax rate of 30 percent and Mr. X is subject to a combined federal/provincial tax rate on non-eligible dividends received of 33 percent.

**ANALYSIS** A comparison of the after tax flow through, with and without the intercompany dividend deduction, would be as follows:

| | No Deduction | Deduction |
|---|---|---|
| Company Y Income | $1,000 | $1,000 |
| Corporate Taxes At 30 Percent | ( 300) | ( 300) |
| Dividends To Company X | $ 700 | $ 700 |
| Corporate Taxes At 30 Percent | ( 210) | Nil |
| Dividends To Mr. X | $ 490 | $ 700 |
| Personal Taxes At 33 Percent | ( 162) | ( 231) |
| After Tax Retention | $ 328 | $ 469 |

12-12. Without the deduction, the after tax retention is only $328. This means that the total tax rate on the $1,000 of income earned by Company Y is an almost confiscatory 67.2 percent. While the application of the dividend deduction provides a more reasonable level of taxation, you should note that the combined corporate and personal tax on the $1,000 income stream

is $531 ($300 + $231). This heavy level of taxation reflects the fact that, with a corporate tax rate of 30 percent, flowing income through a corporation can result in the payment of higher taxes than would be the case with the direct receipt of income. This point is discussed more fully in Chapter 13, which provides detailed coverage of the concept of integration. The concept was introduced in Chapter 7 within our material on the taxation of dividend income.

## Exercise Twelve - 2

**Subject:** Corporate Taxable Income

The Chapman Company had Net Income For Tax Purposes for the year ending December 31, 2019 of $263,000. This amount included $14,250 in taxable capital gains, as well as $14,200 in dividends received from taxable Canadian corporations. Also during 2019, the Company made donations to registered charities of $8,600. At the beginning of the year, the Company had available a non-capital loss carry forward of $82,000, as well as a net capital loss carry forward of $18,000 [(1/2)($36,000)]. Determine the Company's minimum Taxable Income for the year ending December 31, 2019 and the amount and type of any carry forwards available at the end of the year.

**SOLUTION available in print and online Study Guide.**

### *Dividends From Untaxed Income*

12-13. While the preceding justifications for not taxing intercorporate dividends make sense in the majority of situations, problems can arise. One problem involves situations in which the corporation paying the dividend was not taxed on the funds prior to their distribution. Given the fact that, for most companies, accounting income is higher than Taxable Income, it would not be surprising to find cases where there is sufficient accounting income to warrant a dividend payment, combined with a tax loss for the period.

12-14. In this case, there will be no taxation of the original income at the corporate level. This means that only personal taxes will be paid on the income stream and, as a consequence, the use of a corporation will result in a significantly lower level of taxation than would be the case if the income was received directly by the individual. In addition, because no tax will be assessed until the income is paid out in dividends, this situation may result in a significant deferral of the taxation that is applicable to the income stream.

### *Term And Other Preferred Shares*

12-15. A further problem arises when corporations attempt to achieve what is sometimes referred to as "after tax financing". Because of the favourable tax treatment given to both individual and corporate recipients of dividend income, rates that corporations will have to pay on preferred shares will sometimes be lower than rates paid on debt securities.

12-16. For most corporations, debt securities will continue to remain attractive because the tax deductibility of interest payments provides a lower after tax cost of funds than would be the case with the use of preferred shares. However, this is not the case when the corporation is in a loss position and, as a consequence, such companies have often issued preferred shares.

12-17. To make these preferred shares more attractive to investors, issuers add features such as redemption provisions. These features produce a preferred share that has most of the characteristics of debt. In fact, IAS 32, *Financial Instruments: Presentation*, may require that such preferred shares be treated as debt for accounting purposes.

12-18. Despite many debt-like features, the payments made on such preferred shares are, for tax purposes, dividend income. As previously discussed, this type of income is taxed very favourably in the hands of individual investors and is not taxed at all in the hands of corporate investors.

12-19. The loss of tax revenues on this type of security could be very high. To prevent this loss, the ITA either imposes special taxes under Part IV.1 and Part VI.1, or denies the dividend deduction to alter the treatment of dividends on these preferred shares. However, these provisions go beyond the scope of this material.

### *Dividends On Shares Sold For Loss (Stop Loss Rules)*

12-20. As the declaration and payment of dividends by a corporation reduces the corporation's net assets, it would be expected that the value of the shares would fall by approximately the amount of any dividend declared and paid. Given this, it would be possible for one corporation to acquire shares in another corporation at a time when it was anticipated that a dividend would be paid on the acquired shares. The dividends on these shares could be received tax free and, if the value of the shares declined when they went ex-dividend, they could be sold to create a capital loss. The following example illustrates the problem that is created by this situation:

> **EXAMPLE** On June 30, 2019, Brian Company acquires 1,000 shares of Leader Company, a public company, at a cost of $20 per share. On July 1, 2019, the Leader Company declares and pays its regular $3 per share dividend. Because this dividend had been anticipated by the market, the price of the Leader Company stock falls $3 per share to $17 per share. On July 15, 2019, Brian Company sells all of its Leader Company shares at a price of $17 per share.
>
> **ANALYSIS** In the absence of a special rule, the preceding situation would provide very favourable results for Brian Company. They would have received $3,000 in dividends which, because of the deduction for intercorporate dividends, would not be included in their Taxable Income. In addition, they would have a potentially deductible capital loss of $3,000 on the disposition of the shares.

12-21. To prevent this from happening, ITA 112(3) and (3.01) contain "stop loss" rules applicable to shares held as capital property, and ITA 112(4) and (4.01) contain similar rules for shares held as inventory. Under these rules, any loss resulting from a disposition of shares by a corporation must be reduced by the amount of dividends received that are eligible for deduction under ITA 112(1). These rules apply if:

- the shares are held for less than one year; or
- the corporation holding the shares, along with other non-arm's length persons, owns more than 5 percent of the class of shares on which the dividend was received.

12-22. In the preceding example, since the Brian Company held the shares for less than one year, the $3,000 capital loss would be eliminated by the $3,000 dividend received. The second condition, whether the Brian Company owns more than 5 percent of the class of shares, is not relevant given the length of time the shares were owned.

## Exercise Twelve - 3

**Subject:** Stop Loss Rules

On June 16, 2018, Loren Ltd. acquires 1,000 of the 10,000 shares of Manon Inc. at a cost of $25.30 per share. On July 1, 2019, these shares pay a dividend of $2.16 per share. These are the only dividends that were received on these shares. Loren sells the shares on July 29, 2019 for $21.15 per share. Loren Ltd. has taxable capital gains of $50,000 in the year. What is the amount of the allowable capital loss that Loren Ltd. will include in its tax return for the taxation year ending December 31, 2019?

**SOLUTION available in print and online Study Guide.**

### Foreign Source Dividends Received

12-23. The situation for dividends received from non-resident corporations is more complex. The general rules are discussed in Chapter 7, which notes that foreign source dividends are included in income on a gross basis, before the deduction of any foreign taxes withheld. However, in Chapter 11 we introduced the foreign non-business tax credit provisions. These credits against federal Canadian Tax Payable are designed to compensate the recipient of foreign source non-business income for foreign taxes withheld at source, provided the income has been subject to a reasonable amount of Canadian taxation. You will recall that, in many situations, the credit against Canadian Tax Payable will be equal to the amount of foreign taxes withheld at source. Note that foreign source dividends are generally not deducted in the determination of Taxable Income (the exception to this general rule is foreign affiliate dividends which are covered in Chapter 20).

**We suggest you work Self Study Problem Twelve-2 at this point.**

## Non-Capital Loss Carry Over For A Corporation

### Additional Issues

12-24. As the general rules for loss carry overs are the same for all taxpayers, most of the relevant material on this subject is dealt with in Chapter 11 where we discuss the determination of Taxable Income for individuals. There is, however, an additional problem in calculating the amount of the current year non-capital loss carry over for a corporation. This problem relates to the fact that dividends received from taxable Canadian corporations can be deducted by a corporation in the determination of its Taxable Income. To illustrate this problem, consider the following:

**EXAMPLE** During 2019 Marco Inc. has net taxable capital gains of $30,000 [(1/2)($60,000)], dividends of $25,000 received from taxable Canadian corporations, and a net business loss of $60,000. The Company also has a net capital loss carry forward of $50,000 [(1/2)($100,000)].

**ANALYSIS** Using the ITA 3 rules for calculating Net Income For Tax Purposes, the result would be as follows:

| | | |
|---|---|---|
| ITA 3(a) | Dividends Received | $25,000 |
| ITA 3(b) | Net Taxable Capital Gains | 30,000 |
| ITA 3(c) | Subtotal | $55,000 |
| ITA 3(d) | Net Business Loss | ( 60,000) |
| Net Income For Tax Purposes And Taxable Income | | Nil |

12-25. From an intuitive point of view, it would appear that the non-capital loss for the year is $5,000, the ITA 3(c) subtotal less the net business loss. Further, as Net Income is nil, it appears that none of the net capital loss carry forward can be deducted, despite the $30,000 taxable capital gain. In addition, it does not appear that the Company will get any benefit from the potential deduction of the $25,000 in dividends that were received during the year. Fortunately, the ITA 111(8) definition of non-capital loss solves both of these problems.

### An Expanded Definition

12-26. You may recall that the ITA 111(8) definition was discussed previously in Chapter 11. In that material, we explained how the definition permits a net capital loss carry over to be deducted even in cases where current year losses result in a nil Net Income For Tax Purposes. In effect, the definition allows a net capital loss carry over to be converted to a non-capital loss carry over.

12-27. In the Chapter 11 discussion, we were dealing only with the Taxable Income of individuals. Given this, we did not consider the additional problem that arises with the fact that dividends received by a corporation can be deducted in the calculation of corporate Taxable

Income. While this was not apparent from the simplified version of the non-capital loss definition that was presented in Chapter 11, a more complete version of the ITA 111(8) definition deals with this problem. The expanded definition is as follows:

**ITA 111(8)** The non-capital loss of a taxpayer for a taxation year means the amount determined by the formula:

**A – D**, where

**A** is the amount determined by the formula:

**E – F**, where

**E** is the total of all amounts each of which is the taxpayer's loss for the year from an office, employment, business or property, the taxpayer's allowable business investment loss for the year, net capital loss carry overs deducted in the calculation of Taxable Income for the year (this amount cannot exceed the taxable capital gains for the year), and **dividends received from taxable Canadian corporations and deducted in computing Taxable Income**.

**F** is the amount of income determined under ITA 3(c). [Sum of ITA 3(a) non-capital positive sources and ITA 3(b) net taxable capital gains, less Division B, Subdivision e deductions.]

**D** is the taxpayer's farm loss for the year.

12-28. The only difference in this definition from the one that was presented in Chapter 11 is the addition of "dividends received from taxable Canadian corporations and deducted in computing Taxable Income" in the E component. However, it is an important change in that it allows dividends that cannot be deducted because of insufficient Net Income For Tax Purposes to be added to the non-capital loss carry over balance.

## Example

12-29. All of these points can be illustrated by returning to the example presented in Paragraph 12-24. If we assume that Marco Inc. wishes to deduct the maximum amount of the net capital loss carry forward in 2019, the Net Income For Tax Purposes and Taxable Income would still be nil and the non-capital loss for the year would be calculated as follows:

| | | |
|---|---|---|
| Amount E: | | |
| Net Business Loss | | $ 60,000 |
| Dividends Received And Deducted | | 25,000 |
| Net Capital Loss Carry Forward Deducted (Limited To Net Taxable Capital Gains For The Year) | | 30,000 |
| Total For Amount E | | $115,000 |
| Amount F - ITA 3(c) Income: | | |
| Dividends Received | ($25,000) | |
| Net Taxable Capital Gains | ( 30,000) | ( 55,000) |
| Non-Capital Loss For The Year | | $ 60,000 |
| | | |
| Net Capital Loss Carry Forward ($50,000 - $30,000) | | $ 20,000 |

12-30. Note the results of applying the non-capital loss definition. In effect, if there is not sufficient Net Income to allow their deduction in the calculation of Taxable Income, both dividends and net capital loss amounts deducted can be added to the non-capital loss carry over balance. Although subject to a 3 year carry back, 20 year carry forward limit, the loss carry over can be deducted against any type of income.

## Exercise Twelve - 4

**Subject:** Non-Capital Loss With ABIL

For the taxation year ending December 31, 2019, Hacker Inc. has business and property income of $63,500. Also during this year, capital asset dispositions result in capital gains of $23,100 and capital losses of $38,400. The Company experiences a further loss on the arm's length sale of shares of a small business corporation in the amount of $151,500. Determine Hacker Inc.'s Net Income For Tax Purposes for 2019. Indicate the amount and type of any loss carry overs available at the end of the year.

## Exercise Twelve - 5

**Subject:** Non-Capital Loss Carry Forward

The following information is for Loser Ltd., a Canadian public company, for the taxation year ending December 31, 2019:

| | |
|---|---|
| Capital Gains On Capital Asset Sales | $111,000 |
| Capital Losses On Public Company Stock Sales | 84,000 |
| Allowable Business Investment Loss | 5,250 |
| Dividends Received From Taxable Canadian Corporations | 48,000 |
| Canadian Source Interest Income | 27,200 |
| Net Business Loss | 273,000 |

The Company has available a net capital loss carry forward of $19,000. It would like to deduct this loss during 2019. Determine the non-capital loss balance [ITA 111(8)] and net capital loss carry forward for Loser Ltd. at the end of the 2019 taxation year.

**SOLUTIONS available in print and online Study Guide.**

## Ordering Of Taxable Income Deductions

12-31. Chapter 11 covered the specific ordering rules in ITA 111.1 for claiming deductions in the calculation of Taxable Income. However, these rules are directed at individuals and do not apply to corporations. The *Act* does not contain an equivalent provision for corporations and, as a consequence, there is a question as to how deductions should be ordered for a corporation.

12-32. Charitable donations in excess of 75 percent of Net Income For Tax Purposes are not deductible in the current year, but can be carried forward for five years, subject to the same 75 percent limitation in those years. As this is shorter than the carry forward period for any other type of loss, this would suggest using these amounts prior to claiming loss carry forwards. However, in reaching this conclusion, it should be noted that these donations can be deducted against any type of income.

12-33. Turning to the deduction of loss carry overs, ITA 111(3) requires that losses within any single category must be deducted in chronological order. That is, if a corporation chooses to deduct a portion of its non-capital loss balance during the current year, the oldest losses of this type must be deducted first. However, there are no rules with respect to the order in which the individual types of loss carry forwards must be deducted.

12-34. Farm loss carry forwards and non-capital loss carry forwards have restrictions on the time for which they are available. This would suggest that they be deducted first. However, while there is no restriction on the period of availability for capital loss carry forwards, these amounts can only be used to the extent that there are net taxable capital gains during the period.

12-35. For a corporation that experiences only limited capital gains, these restrictions may be a more important consideration than the period of time during which the loss will be available. With the carry forward period for non-capital losses lasting 20 years, this would appear to leave plenty of time to recover this type of loss.

12-36. An additional factor in making decisions on whether to deduct non-capital or farm losses is the period left to their expiry. Clearly, items that expire in the current year should be deducted immediately, with additional consideration given to items near the end of their carry forward period.

**We suggest you work Self Study Problems Twelve-3 and 4 at this point.**

# Geographical Allocation Of Income

## Permanent Establishments

12-37. After Taxable Income is calculated, in order to determine the amount of provincial taxes that are payable and the province(s) to which they are due, it is necessary to allocate the income of the corporation to the various provinces. Given the variations in provincial tax rates on corporations, this can be a matter of considerable significance.

12-38. The key concept here is the idea of a "permanent establishment". This concept is defined as follows:

> **ITR 400(2)** Permanent establishment means a fixed place of business of the corporation, including an office, a branch, a mine, an oil well, a farm, a timberland, a factory, a workshop or a warehouse.

12-39. This meaning has been extended to include having an agent or employee in a province, if that agent or employee has the general authority to contract for a corporation, or carries a stock of merchandise from which orders are regularly filled. The mere presence of a commission salesperson or an independent agent is not considered evidence of a permanent establishment. In addition, the presence of a controlled subsidiary in a province is not necessarily indicative of a permanent establishment.

12-40. However, ITR 400(2)(d) indicates that where a corporation that has a permanent establishment anywhere in Canada owns land in a province, such land will be deemed to be a permanent establishment. In addition, ITR 400(2)(e) indicates that where a corporation uses substantial machinery or equipment in a particular place, that corporation shall be deemed to have a permanent establishment in that place.

## Activity At Permanent Establishments

12-41. Once the location of permanent establishments has been determined, income will be allocated on the basis of two variables. These are gross revenues from the permanent establishment, and salaries and wages paid by the establishment.

12-42. After these values are established, ITR 402(3) provides a formula for using these variables to allocate Taxable Income to provinces. It requires calculating, for each province, that province's gross revenues as a percentage of total corporate gross revenues, and that province's salaries and wages as a percentage of total corporate salaries and wages. A simple average of these two percentages, without regard to the relative dollar values associated with the corporate totals, is then applied to corporate Taxable Income to determine the amount of Taxable Income that will be allocated to that province.

12-43. Note that, if the corporation has permanent establishments outside of Canada, not all of its Taxable Income will be allocated to a province. The presence of these foreign permanent establishments will be reflected in the calculation of the federal tax abatement (see Paragraph 12-46). If there are no permanent establishments outside of Canada, the federal tax abatement will be the full 10 percent, even if there is foreign investment income.

## Example - Permanent Establishments

12-44. The following example illustrates the process of allocating Taxable Income on a geographic basis:

**EXAMPLE** The Linford Company has permanent establishments in Alberta, Manitoba, and Ontario. The Company's Taxable Income for the current year totaled $100,000, with gross revenues of $1,000,000 and salaries and wages of $500,000.

The following allocation of the gross revenues and the salaries and wages among the provinces occurred during the current year:

| | Gross Revenues | | Salaries And Wages | |
|---|---|---|---|---|
| **Province** | Amount | Percent | Amount | Percent |
| Alberta | $ 250,000 | 25.0 | $100,000 | 20.0 |
| Manitoba | 400,000 | 40.0 | 200,000 | 40.0 |
| Ontario | 350,000 | 35.0 | 200,000 | 40.0 |
| Totals | $1,000,000 | 100.0 | $500,000 | 100.0 |

**ANALYSIS** Using the average of the two percentages for each province, the Linford Company's Taxable Income would be allocated to the three provinces as follows:

| **Province** | **Average Percent** | **Taxable Income** | **Amount Allocated** |
|---|---|---|---|
| Alberta | 22.5 | $100,000 | $ 22,500 |
| Manitoba | 40.0 | 100,000 | 40,000 |
| Ontario | 37.5 | 100,000 | 37,500 |
| Totals | 100.0 | N/A | $100,000 |

**We suggest you work Self Study Problem Twelve-5 at this point.**

# Federal Tax Payable

## Basic Rate

12-45. All corporations are initially subject to the same basic tax rate. This rate is specified in ITA 123 and, for many years, has been set at 38 percent.

## Federal Tax Abatement

12-46. ITA 124(1) provides a reduction of 10 percentage points in the federal tax rate. This is normally referred to as the federal tax abatement and it is designed to leave room for the provinces to apply their respective tax rates. When deducted from the basic rate of 38 percent, this leaves a net federal rate of 28 percent.

12-47. Note that this 10 percentage point reduction in the federal tax rate is only applicable to income earned in a Canadian province or territory. When a corporation has foreign operations in permanent establishments outside of Canada, less than 100 percent of its income will be allocated to the various provinces and territories. When this is the case, the amount of abatement to be deducted is reduced by multiplying the 10 percent abatement by the total percentage of Taxable Income that was allocated to the provinces and territories. For example, if only 80 percent of a corporation's Taxable Income was allocated to one or more provinces, the abatement would effectively be reduced to 8 percent [(10%)(80%)].

## General Rate Reduction

### General Rate Reduction Percentage

12-48. In implementing changes in the federal rate on corporations, the government has decided to use a process which maintains the basic rate of 38 percent. When changes are required, the desired result is accomplished by using a "general rate reduction percentage". This percentage is applied to what is referred to as "full rate taxable income" (see explanation which follows). Since 2011, the general rate reduction percentage has been 13 percent.

12-49. In those situations where all of a corporation's income is both allocated to a province and eligible for the general rate reduction, the corporate rate at the federal level is 15 percent:

| | |
|---|---|
| Basic Corporate Rate | 38% |
| Less: Federal Tax Abatement | (10%) |
| Balance | 28% |
| Less: General Rate Reduction | (13%) |
| General Federal Corporate Rate | 15% |

### Full Rate Taxable Income

12-50. As noted, the "general rate reduction percentage" must be applied to "full rate taxable income". In fairly simple terms, full rate taxable income is income that does not benefit from certain other tax privileges. The most common of these privileges are the small business deduction, the manufacturing and processing profits deduction (M&P deduction), and the refundability of certain types of taxes on the investment income of private companies.

12-51. Both the small business deduction and the M&P deduction are discussed later in this Chapter. Full Rate Taxable Income will also be considered in this Chapter, with detailed coverage beginning at Paragraph 12-149. The coverage of refundable taxes on the investment income of private companies will not be dealt with until Chapter 13.

### Exercise Twelve - 6

**Subject:** Geographical Allocation And Federal Tax Payable

Sundown Ltd., a Canadian public company, has Taxable Income for the taxation year ending December 31, 2019 in the amount of $226,000. It has Canadian permanent establishments in Ontario and Manitoba. The Company's gross revenues for the 2019 taxation year are $2,923,000, with $1,303,000 of this accruing at the permanent establishment in Ontario, and $896,000 accruing at the permanent establishment in Manitoba. Wages and salaries total $165,000 for the year. Of this total, $52,000 is at the permanent establishment in Ontario and $94,000 is at the permanent establishment in Manitoba. Sundown has sales to the U.S. through a U.S. permanent establishment. Calculate federal Tax Payable for the taxation year ending December 31, 2019. Ignore any foreign tax implications.

**SOLUTION available in print and online Study Guide.**

# Provincial Tax Payable

## General Rules

12-52. In calculating Tax Payable for individuals, a graduated rate structure is involved at both the federal and provincial levels. While limits on the brackets may differ from those used at the federal level, all of the provinces assess taxes on individuals using graduated rates applied to Taxable Income.

**Figure 12 - 3**
**Combined Federal/Provincial Corporate Rates - March 31, 2019**

| | General Rate | M&P Rate | Small Business Rate |
|---|---|---|---|
| Federal Tax Only | 15.0% | 15.0% | 9.0% |
| **Combined Federal/Provincial** | | | |
| Alberta | 27.0% | 27.0% | 11.0% |
| British Columbia | 27.0% | 27.0% | 11.0% |
| Manitoba | 27.0% | 27.0% | 9.0% |
| New Brunswick | 29.0% | 29.0% | 11.5% |
| Newfoundland | 30.0% | 30.0% | 12.0% |
| Nova Scotia | 31.0% | 31.0% | 12.0% |
| Ontario | 26.5% | 25.0% | 12.5% |
| Prince Edward Island | 31.0% | 31.0% | 12.5% |
| Quebec | 26.6% | 26.6% | 15.0% |
| Saskatchewan | 27.0% | 25.0% | 11.0% |

12-53. In contrast, provincial corporate taxes are based on a flat rate applied to a Taxable Income figure. With the exception of Alberta and Quebec, the federal Taxable Income figure is used. While these two provinces collect their own corporate taxes, the Taxable Income figure that they use is normally similar to that used at the federal level.

## General Rate

12-54. As calculated in Paragraph 12-49, the general federal corporate rate is 15 percent. When the varying provincial rates are added to this percentage, Figure 12-3 shows that the general corporate tax rate ranges from a low of 26.5 percent in Ontario, to a high of 31 percent in Nova Scotia and Prince Edward Island.

## Manufacturing And Processing Rate

12-55. For many years, manufacturing and processing (M&P) income has been eligible for a tax deduction at the federal level. As discussed later in this Chapter, the deduction still exists. However, since the introduction of the general rate reduction (covered later in this Chapter), any income that qualifies for the M&P deduction also qualifies for the general rate reduction. As shown in Figure 12-3, the federal M&P rate (15 percent) is identical to the federal general rate (15 percent). As will be discussed later in this Chapter, the base for the general rate reduction is reduced by amounts eligible for the M&P deduction, so that the M&P deduction is not of any benefit to corporations in terms of federal Tax Payable.

12-56. This is also the situation with all but two of the provinces. At one time, there were more provinces with reduced M&P rates, but now only Ontario and Saskatchewan apply reduced rates to this type of income. Because it is still relevant in these two provinces, we provide coverage of the M&P deduction in this Chapter.

## Small Business Rate

12-57. The lowest rates in Figure 12-3 are referred to as the small business rates. As will be discussed later in this Chapter, Canadian controlled private corporations (CCPCs) are eligible for a small business deduction that lowers the federal rate to 9 percent on a limited amount of income. In general, the availability of this reduced rate is limited to the first $500,000 of active business income earned in a year.

12-58. All of the provinces, with the exception of Saskatchewan, also apply their small business rate to the first $500,000 of active business income. Saskatchewan uses an increased limit of $600,000.

12-59. When the reduced federal and provincial rates are combined, the resulting rates range from a low of 9 percent in Manitoba, to a high of 15 percent in Quebec. You might note that the 15 percent rate for Quebec is significantly higher than the rate in other provinces. The next highest rate is 12.5 percent in Ontario and Prince Edward Island.

### Investment Income Rates

12-60. While this is not illustrated in Figure 12-3, different rates are applicable to certain types of investment income. We will provide coverage of these rates in Chapter 13.

### Other Provincial Taxes

12-61. At one time, provincial taxes on corporate capital were fairly common. However, though some provinces levy capital taxes on specific types of entities (e.g., financial institutions), none of the provinces has a general tax on corporate capital.

12-62. Several provinces currently levy payroll taxes, often to fund the provincial health care system. For example, Ontario has a payroll tax on annual payrolls totalling more than $450,000.

## Other Goals Of The Corporate Tax System

12-63. If raising revenues was the only goal of the corporate taxation system, there would be nothing much to discuss with respect to this matter, and there would be little need for the Chapters on corporate taxation that follow. However, in addition to raising revenues, the Canadian corporate taxation system has been structured to accomplish a number of other objectives. These include:

- **Incentives For Small Business** While there are several features of the tax system directed at encouraging small businesses, the major tax incentive for these organizations is the small business deduction.
- **Incentives For Certain Business Activities** The Canadian tax system provides generous investment tax credits for scientific research as well as for the employment of apprentices. Support is also provided to the natural resource industries through a variety of programs.
- **Incentives For Certain Regions** Certain regions of Canada are given assistance through investment tax credits and other programs.
- **Integration** One of the goals of the Canadian tax system is to keep the level of taxes paid on a given stream of income the same, regardless of whether or not a corporation is placed between the original source of the income and the ultimate recipient.

12-64. The small business deduction and the manufacturing and processing profits deduction will be examined in this Chapter. Integration will be dealt with in detail in Chapter 13. Our material on scientific research and experimental development expenditures and investment tax credits can be found in Chapter 14.

## Small Business Deduction

### Introduction

12-65. It has been a longstanding goal of the Canadian taxation system to provide incentives to small business. The underlying assumption is that, particularly during their formative years, these businesses need some degree of tax relief in order to allow them to accumulate the capital required for expansion. In very simplified terms, the small business deduction provides a deduction against the Tax Payable of a Canadian controlled private corporation.

12-66. Over the last 3 years, the deduction has been increased from 17.5 percent in 2017, to 18 percent in 2018, and to 19 percent for 2019 and subsequent years.

12-67. The federal deduction is only available on the first $500,000 of active business income. While almost all provinces use the same $500,000 limit, we have noted previously the Saskatchewan limit is $600,000.

12-68. A simple example will serve to illustrate the application of this deduction.

**EXAMPLE** A Canadian controlled private corporation has Taxable Income of $100,000 for the year ending December 31, 2019. All of this income is earned in Canada and eligible for the small business deduction. The provincial tax rate applicable to income eligible for the small business deduction is 3 percent.

**ANALYSIS** The corporation's Tax Payable would be calculated as follows:

| | |
|---|---|
| Base Amount Of Part I Tax [(38%)($100,000)] | $38,000 |
| Federal Tax Abatement [(10%)($100,000)] | ( 10,000) |
| Small Business Deduction [(19%)($100,000)] | ( 19,000) |
| General Rate Reduction (Note) | Nil |
| Federal Tax Payable | $ 9,000 |
| Provincial Tax Payable [(3%)($100,000)] | 3,000 |
| Total Tax Payable | $12,000 |

**Note** As explained later in this Chapter, the general rate reduction is not available on income that is eligible for the small business deduction.

12-69. As can be seen in the example, when the small business deduction is available, it reduces the federal rate to 9 percent ($9,000 ÷ $100,000). We have also applied a provincial rate of 3 percent (roughly the average provincial rate). This produces a combined federal/provincial rate of 12 percent ($12,000 ÷ $100,000).

12-70. The small business deduction provides a significant incentive to businesses that qualify. Only certain types of corporations qualify for this deduction and it is only available on certain amounts and types of income. The criteria for qualification can be described in non-technical terms as follows:

**Type Of Corporation** The availability of the small business deduction is restricted to Canadian controlled private corporations (CCPCs).

**Type Of Income** The deduction is only available on income earned in Canada that qualifies as "active business income". This would include the income of professional corporations and management companies, provided they are private and Canadian controlled. However, the income of specified investment businesses and personal services corporations (see definitions later in this Chapter) does not qualify.

**Limit On Amount** The federal deduction is available on the first $500,000 of active business income earned in a year. This amount is referred to as the annual business limit and, in some circumstances, it is subject to a reduction formula.

**Associated Corporations** The $500,000 annual business limit must be shared among associated corporations.

12-71. The issues associated with these criteria are discussed in the material that follows.

## Canadian Controlled Private Corporation (CCPC)

12-72. CCPCs are defined in ITA 125(7) as private corporations that are not controlled, directly or indirectly, by one or more non-resident persons, by one or more public corporations, or a combination of non-resident persons and public corporations. In addition, corporations that have shares listed on a designated stock exchange, in or outside of Canada, do not qualify as CCPCs.

## Active Business Income

### The General Idea

12-73. ITA 125(7) contains the following definition of "active business":

> **Active business carried on by a corporation** means any business carried on by the corporation other than a specified investment business or a personal services business and includes an adventure or concern in the nature of trade.

12-74. While the preceding defines active business, a further definition in ITA 125(7) defines income from an active business as follows:

> **Income of the corporation for the year from an active business** means ... the income of the corporation for the year from an active business carried on by it, including any income for the year pertaining to or incident to that business, other than income for the year from a source in Canada that is a property ... [The definition goes on to cover an amount under ITA 12(10.2) that is of no interest to users of this material.]

12-75. While this definition is not a model of clarity, it expresses the basic idea that active business income involves "doing something" to produce income. The concept excludes what is usually referred to as property income. Property income is distinguished by the fact that it generally becomes available with little or no effort on the part of the recipient (e.g., interest earned on long-term bonds).

### The Problem With Defining Property Income

12-76. As noted, the preceding definitions of active business and active business income are largely directed towards excluding property income such as interest, dividends, and rents from eligibility for the small business deduction. The federal government does not wish to allow individuals to have access to the small business deduction by simply placing their passive investments in the shelter of a Canadian controlled private corporation. However, a blanket exclusion of property income is inappropriate since there are corporations that are "actively" involved in earning such income.

12-77. The difficulty is in finding a way to distinguish between corporations that are simply being used as tax shelters for property or passive income, and corporations that engage in active property management. For example, if a corporation has a single residential rental property, the rents from this property would undoubtedly be viewed as passive income.

12-78. Alternatively, a corporation that owns a chain of hotels with more than 10,000 rooms would certainly be entitled to view the rentals of these properties as an active business. The question is, at what point does the corporation cross the line between earning passive investment income and active business income?

12-79. Similar, but less obvious problems arise with interest income. If a corporation has no activity other than collecting interest on term deposits, the amounts that it earns would almost certainly be viewed as passive investment income. Alternatively, interest earned by a company actively involved in providing mortgage financing to corporate clients could be viewed as business income. Again, a problem exists in finding the point at which a crossover is made between the two situations.

### The Solution - Specified Investment Business

12-80. The concept of a "specified investment business" provides a somewhat arbitrary solution to this problem. The term is defined in ITA 125(7) as follows:

> **Specified Investment Business** carried on by a corporation in a taxation year, means a business (other than a business carried on by a credit union or a business of leasing property other than real or immovable property) the principal purpose of which is to derive income (including interest, dividends, rents and royalties) from property but, except where the corporation was a prescribed labour-sponsored venture capital corporation at any time in the year, does not include a business carried on by the corporation in the year where

(i) the corporation employs in the business throughout the year more than five full-time employees, or

(ii) any other corporation associated with the corporation provides, in the course of carrying on an active business, managerial, administrative, financial, maintenance or other similar services to the corporation in the year and the corporation could reasonably be expected to require more than five full-time employees if those services had not been provided.

12-81. As the activities of these specified investment businesses are excluded from the definition of active business, it means that income from property generated by such businesses is not eligible for the small business deduction. Stated alternatively, for corporations that are primarily engaged in earning income from property, the *Act* specifies that only those with more than five full-time employees involved in earning such income are considered to be earning active business income and eligible for the small business deduction.

12-82. While this is an arbitrary solution to the problem of distinguishing between active and passive investment income from a business, it does serve to resolve most of the uncertainty in this area. With respect to interpreting this rule, IT-73R6 states that "more than five full-time employees" means that at least six employees are working full business days on each working day of the year. However, this interpretation has been overturned in a Tax Court of Canada Decision (489599 B.C. Ltd. vs. The Queen).

12-83. In this decision, the court indicated that a combination of five full-time employees and one part-time employee would constitute "more than five full-time employees". While IT-73R6 is archived and will not be revised to reflect the results in this case, the CRA has indicated that they accept this decision and will rule accordingly in future applications of the specified investment business definition.

### Incidental Property Income

12-84. The definition of active business income includes incidental property income that is earned by a corporation engaged in an active business. In this regard, many corporations experience temporary excess cash balances, and these balances will usually be invested in interest bearing assets. Within reasonable limits, such interest can be included as a component of active business income. In similar fashion, revenues resulting from temporary rentals of excess space may be included in active business income.

### Property Income Received From An Associated Corporation

12-85. Income from a specified investment business and non-incidental property income earned by a CCPC do not qualify for the small business deduction. However, when a corporation derives income from holding property, and the income is received from an associated company that deducted the amounts in computing active business income, ITA 129(6)(b) deems the income to be active business income to the recipient.

12-86. The logic behind this is that, while the amounts received by one of the associated companies must be considered property income, because of its legal form, the deduction by the payer corporation reduces the total active business income within the associated group.

**EXAMPLE** Lardin Inc. is associated with Dwarm Ltd. Lardin lends $100,000 to Dwarm to use in active business activities. During the current year, Dwarm pays $6,000 of interest to Lardin.

**ANALYSIS** Normally, Lardin could not classify the interest received as active business income. However, if Dwarm is earning active business income, the payment to Lardin reduced the amount of this income, as well as the total active business income of the associated group. In order to prevent this reduction, the recipient corporation is allowed to treat such interest as active business income.

## Annual Business Limit

12-87. The federal limit on the amount of active business income that is eligible for the small business deduction is $500,000 per taxation year. As discussed in the paragraph which follows, this annual limit must be shared by associated corporations. In addition, as will be discussed beginning at Paragraph 12-102, this $500,000 limit will be reduced for CCPCs with either Taxable Capital Employed in Canada in excess of $10 million or ADJUSTED Aggregate Investment Income in excess of $50,000 in the previous year. We have capitalized ADJUSTED to avoid confusion with Aggregate Investment Income (see Paragraph 12-142).

## Allocation Among Associated Companies

12-88. In the absence of special rules, it would be very easy to avoid the annual limit that applies to the small business deduction. This could be accomplished by dividing a single corporation's activities between two separate corporations, thereby doubling up on the annual business limit of $500,000. However, the *Act* prevents this by requiring that associated companies share their annual business limit.

12-89. In some cases, association is fairly obvious. If, for example, a single individual owned all of the shares to two separate corporations, these corporations are clearly associated. However, a complete coverage of this subject becomes very complex. Because of this, we have allocated our detailed coverage of this subject to Chapter 14, Other Issues In Corporate Taxation.

12-90. While we are deferring our detailed coverage of this subject, we would note here that a group of associated companies can allocate the $500,000 limit in any manner that they wish. It can be divided equally among the group, allocated 100 percent to a single member of the group, or split in any proportions that the group chooses to use.

## Calculating The Small Business Deduction

### The General Formula

12-91. After noting that to qualify for this deduction, a corporation must be a CCPC throughout the year, ITA 125(1) specifies that the deduction from federal Tax Payable is equal to 19 percent of the least of three figures (note that for ease of reference, this formula is included at the front of this text in "Rates and Other Data"):

(a) Net Canadian active business income.

(b) Taxable Income, less:

  (i) 100/28 times the ITA 126(1) credit for taxes paid on foreign non-business income, calculated without consideration of the additional refundable tax under ITA 123.3 (see Chapter 13) or the general rate reduction under ITA 123.4; and

  (ii) 4 times the ITA 126(2) credit for taxes paid on foreign business income, calculated without consideration of the general rate reduction under ITA 123.4 (see Note)

(c) The annual business limit of $500,000, less any portion allocated to associated corporations, less any Taxable Capital Employed In Canada or ADJUSTED Aggregate Investment Income grind. (These grinds are explained later in this Chapter.)

**Note** ITA 125(1)(b)(ii) actually has a more complicated calculation as follows:

... the amount determined by the formula

$$1 \div (A - B), \text{ where}$$

**A** is the percentage set out in paragraph 123(1)(a) [the basic federal rate of 38 percent], and

**B** is the percentage that is the corporation's general rate reduction percentage (as defined by section 123.4) for the taxation year [13 percent].

Given these numbers, ITA 125(1)(b)(ii) is calculated as [1 ÷ (.38 - .13)] = 4. We will use this number 4 in all of our examples and problems, without showing the complete calculation.

## Constraints - Type Of Income And Annual Business Limit

12-92. We have already noted that the deduction is only available on active business income earned in Canada, the item A constraint. We have also noted that the annual business limit of $500,000, the item C constraint, must be shared by associated companies.

## Constraints - Taxable Income

12-93. With respect to the limit which uses Taxable Income, we would note that active business income earned during the taxation year is included in Net Income For Tax Purposes. In many cases, this amount will also be included in full in Taxable Income. However, it is possible that large Division C deductions could eliminate all or part of this income from the Taxable Income total. Examples of such Division C deductions would be as follows:

- charitable donations
- non-capital loss carry overs
- farm loss carry overs

12-94. You will notice that neither dividends nor net capital losses are included in this list. This reflects the fact that these amounts can only be deducted to the extent that either dividends or taxable capital gains are included in Net Income. Given this, they cannot serve to offset amounts of active business income that are included in Net Income For Tax Purposes.

12-95. A simple example will illustrate the need for this Taxable Income constraint on the small business deduction:

**EXAMPLE** During the current year, Allard Ltd. has active business income of $123,000, taxable capital gains of $15,000, and dividends received from taxable Canadian corporations of $50,000. At the beginning of the year, Allard Ltd. has a net capital loss carry forward of $35,000 and a non-capital loss carry forward of $105,000. The Company will use the loss carry forwards to the extent possible during the current year. The calculation of Allard's Net Income For Tax Purposes and Taxable Income would be as follows:

| | |
|---|---|
| Net Income For Tax Purposes | |
| ($123,000 + $15,000 + $50,000) | $188,000 |
| Dividends Received | ( 50,000) |
| Net Capital Loss Carry Forward | |
| (Limited To Taxable Capital Gains) | ( 15,000) |
| Subtotal (Equal To Active Business Income) | $123,000 |
| Non-Capital Loss Carry Forward | ( 105,000) |
| Taxable Income | $ 18,000 |

12-96. Note that if only the net capital loss carry forward and dividends were deducted, Taxable Income would have been equal to the $123,000 in active business income. The problem is the non-capital loss carry forward. It has further reduced Taxable Income to $18,000, an amount well below the active business income.

12-97. If, in this case, the small business deduction was based on active business income, the amount would be $23,370 [(19%)($123,000)]. As this deduction is in excess of the Tax Payable on $18,000 of Taxable Income, this is not a reasonable outcome. The example clearly illustrates the need for the Taxable Income constraint on the small business deduction.

## Constraints - Foreign Tax Credits

12-98. Another concern of the federal government is to ensure that the small business deduction is not provided on income that has not been taxed in Canada. To prevent this from happening, the B component of the ITA 125(1) formula reduces Taxable Income by:

- 100/28 times the ITA 126(1) credit for taxes paid on foreign non-business income, calculated without consideration of the additional refundable tax under ITA 123.3 (see Chapter 13) or the general rate reduction under ITA 123.4; and
- 4 times the ITA 126(2) credit for taxes paid on foreign business income, calculated without consideration of the general rate reduction under ITA 123.4.

12-99. The 100/28 figure is based on the notional assumption that foreign non-business income will be subject to a federal tax rate of 28 percent (i.e., if the credit is equal to the taxes paid at 28 percent, 100/28 times the credit will equal the notional amount of income received).

12-100. In similar fashion, the 4 times figure that is applicable to foreign business income is based on the notional assumption that this income will be subject to a federal tax rate of 25 (1 ÷ 4) percent.

12-101. Based on the preceding analysis, subtracting these amounts from Taxable Income has the effect of removing from this figure the amounts of foreign income on which the foreign tax credit has eliminated the Canadian taxation at the assumed rates of 28 and 25 percent. A simple example can be used to clarify this point:

> **EXAMPLE** A corporation earns $100,000 in foreign non-business income, with $18,000 being withheld by the foreign government.
>
> If this income had been earned in Canada, it is assumed that the tax would be $28,000 (using the notional rate on this type of income of 28 percent). Being received from a foreign source, the $28,000 in Canadian Tax Payable will be offset by the $18,000 foreign tax credit. This will leave a net Canadian Tax Payable of $10,000.
>
> Using the foreign tax credit of $18,000 and an assumed tax rate of 28 percent, the formula removes $64,286 [(100/28)($18,000)] from Taxable Income, leaving $35,714 ($100,000 - $64,286). If we multiply this $35,714 by the notional rate of 28 percent, the result is $10,000, the amount of Canadian tax remaining after the application of the foreign tax credit. This demonstrates how the formula ensures that the small business deduction is not available on Taxable Income on which foreign tax credits have eliminated Canadian taxation.
>
> If the foreign tax withheld and the foreign tax credit had been $28,000 [(28%)($100,000)], the formula would have removed $100,000 [(100/28)($28,000)], or all of the foreign source income.

## Exercise Twelve - 7

**Subject:** Amount Eligible For The Small Business Deduction

Kartoom Ltd. is a CCPC that began operations on January 1, 2019. It is not associated with any other corporation. For the year ending December 31, 2019, Kartoom has Net Income For Tax Purposes of $570,000. This amount is made up of dividends from taxable Canadian corporations of $85,000, active business income of $425,000, and foreign non-business income of $60,000. The foreign income was subject to withholding in the foreign jurisdiction at a rate of 15 percent. Kartoom receives a foreign tax credit against federal Tax Payable that is equal to the amount withheld. Kartoom has a non-capital loss carry forward of $160,000 which it intends to deduct during 2019.

Determine the amount eligible for the small business deduction for the year ending December 31, 2019.

**SOLUTION available in print and online Study Guide.**

## Annual Business Limit Reduction

### Problem I

12-102. As the name implies, the small business deduction was designed to provide assistance to small corporations. For a variety of reasons, including the belief that such corporations have a positive impact on employment growth, and the fact that small corporations often experience financing difficulties in their formative years, the generous tax advantages provided by this deduction were thought to be appropriate.

12-103. However, in designing the small business deduction provisions, eligibility was based on the type of income earned (active business income) and the type of corporation (CCPCs). No consideration was given to the size of the corporation's income or assets. As a consequence, under its usual provisions, some very large private corporations received the benefit of the small business deduction on amounts of active business income that were below the annual business limit. This was clearly not in keeping with the intent of this legislation.

12-104. To deal with this problem, there has been a grind (i.e., a programmed reduction) in the annual business limit for many years. For CCPCs that have Taxable Capital Employed in Canada (TCEC) in excess of $10 million, the annual business limit for the small business deduction is gradually reduced, with the basic $500,000 completely disappearing when the TCEC reaches $15 million.

### Problem II

12-105. A second and more recently identified problem was described in the introductory Note to this Chapter. This is the fact that the low small business rate allows those shareholders that do not need all of the income from their corporation to accumulate large portfolios of passive investments.

12-106. As of 2019, a second grind is applied to the annual business limit. This grind is based on a CCPC's ADJUSTED Aggregate Investment Income. This unique version of investment income, defined in ITA 125(7), is used only for purposes of determining this grind of the small business deduction. In somewhat simplified terms it contains:

- interest, rents and royalties;
- net taxable capital gains on the disposition of capital assets not used in the active business of the corporation;
- dividends received from taxable Canadian corporations with the exception of those from connected corporations (defined in Chapter 13); and
- dividends from foreign corporations with the exception of those from foreign affiliates (defined in Chapter 20)

12-107. This grind is accompanied by some very complex provisions related to the Refundable Dividend Tax On Hand (RDTOH) balance. As we do not cover investment income received by a CCPC or the determination of the RDTOH balance until Chapter 13, there is a case for deferring coverage of this grind until Chapter 13. However, the revised ITA 125(5.1) requires that the overall grind be based on the greater of the Taxable Capital Employed in Canada grind and the ADJUSTED Aggregate Investment Income grind. Because of this relationship, we are providing coverage of both grinds in this Chapter 12. Note, however, our coverage of the ADJUSTED Aggregate Investment Income grind will be limited to the calculation of the small business deduction. When investment income is involved, we cannot illustrate the determination of Tax Payable for a CCPC at this stage.

### Taxable Capital Employed In Canada (TCEC) Grind - ITA 125(5.1)

12-108. The formula for this component of the annual business limit grind is as follows:

$$\textbf{Taxable Capital Employed in Canada REDUCTION} = A \times \frac{B}{\$11{,}250} \text{ where,}$$

**A** is the amount of the corporation's annual business limit for the year ($500,000 or less if shared with associated corporations).

**B** is 0.225 percent (.00225) of the excess over $10 million of the previous year end's total Taxable Capital Employed In Canada of the corporation and any associated companies.

**NOTE** This formula is for the **reduction** of the annual business limit, not for the available balance.

12-109. "Taxable capital employed in Canada" is defined in ITA 181.2. In somewhat simplified terms, it has the following meaning:

**Taxable Capital Employed In Canada (TCEC)** GAAP determined debt and equity capital of the corporation, less certain types of debt and equity investments in other corporations. When not all of the corporation's Taxable Income is allocated to a province, the resulting amount is multiplied by the same percentage that is applied to the abatement in order to determine the portion of the total capital that is employed in Canada.

12-110. The mechanics of this formula are easily understood. If a corporation has $10 million or less TCEC, B will equal nil ($10 million or less, minus the $10 million specified deduction). This means the formula amount will be nil and there will be no reduction in the corporation's annual business limit.

12-111. When the amount of TCEC for the previous year reaches $15 million, B in the formula will be equal to $11,250 [(.00225)($15,000,000 - $10,000,000)]. The annual business limit will then be multiplied by one ($11,250 ÷ $11,250) and the reduction in the annual business limit will be 100 percent of the available amount.

12-112. Not surprisingly, a CCPC that is associated with one or more other corporations in a taxation year ending in a given calendar year will be required to take into account the TCEC of all of these firms.

## Example Of The TCEC Grind

12-113. The following example illustrates the reduction of the small business deduction for a large CCPC:

**EXAMPLE** Largess Inc. is a CCPC with a December 31 year end. All of its income is earned in Canada, and it is not associated with any other corporation. On December 31, 2019, the following information is available:

| | |
|---|---|
| 2019 Active Business Income | $ 523,000 |
| 2019 Taxable Income | 550,000 |
| 2018 Taxable Capital Employed In Canada | 13,700,000 |
| 2018 ADJUSTED Aggregate Investment Income | Nil |

**ANALYSIS** For the preceding year, 2018, B in the reduction formula would be equal to $8,325 [(.00225)($13,700,000 - $10,000,000)]. Using this in the ITA 125(5.1) formula would produce the following reduction in the 2019 annual business limit:

$$\$500{,}000 \times \frac{\$8{,}325}{\$11{,}250} = \underline{\underline{\$370{,}000}}\ \textbf{Reduction}$$

Given this, the reduced annual business limit would be $130,000 ($500,000 - $370,000) and the small business deduction for 2019 would be 19 percent of the least of:

| | |
|---|---|
| Active Business Income | $523,000 |
| Taxable Income | 550,000 |
| Reduced Annual Business Limit ($500,000 - $370,000) | 130,000 |

The reduced annual business limit is the least of the three figures and the 2019 small business deduction would be $24,700 [(19%)($130,000)], a significant reduction from the $95,000 [(19%)($500,000)] that would have been available in the absence of the ITA 125(5.1) requirement for reducing the annual business limit for large CCPCs.

## Exercise Twelve - 8

**Subject:** Taxable Capital Employed In Canada (TCEC) Grind

Largely Small Inc. is a Canadian controlled private corporation. For the year ending December 31, 2019, its Net Income For Tax Purposes is $1,233,000, all of which is active business income, except for $36,000 in foreign source non-business income. Fifteen percent of this amount was withheld in the foreign jurisdiction and the corporation receives a foreign tax credit against federal Tax Payable that is equal to the amount withheld. The corporation's only deduction in the calculation of Taxable Income is for a non-capital loss carry forward of $914,000. The corporation had Taxable Capital Employed In Canada of $11,300,000 for the year ending December 31, 2018, and $11,600,000 for the year ending December 31, 2019. It is not associated with any other corporation. Determine the amount of Largely Small Inc.'s small business deduction for the year ending December 31, 2019.

**SOLUTION available in print and online Study Guide.**

### *ADJUSTED Aggregate Investment Income Grind - ITA 125(5.1)*

12-114. The formula for the ADJUSTED Aggregate Investment Income grind is as follows:

**ADJUSTED Aggregate Investment Income REDUCTION**

$$= \left[\frac{D}{\$500{,}000}\right]\left[(5)(E - \$50{,}000)\right] \text{ where,}$$

**D** is the amount of the corporation's annual business limit for the year ($500,000 or less if shared with associated corporations).

**E** the total of all amounts each of which is the ADJUSTED Aggregate Investment Income of the corporation or of any corporation with which it is associated for the preceding year.

12-115. As we have noted, ADJUSTED Aggregate Investment Income is a unique concept that is only used for the purposes of determining this grind of the annual business limit.

12-116. As was the case with the TCEC grind formula, the ADJUSTED Aggregate Investment Income grind formula is fairly easy to understand. If the CCPC's ADJUSTED Aggregate Investment Income for the previous year is $50,000 or less, there is no reduction in its annual business limit.

**EXAMPLE** Before the grind, DOC Inc. has an annual business limit of $500,000 and ADJUSTED Aggregate Investment Income for the previous year of $50,000. Its TCEC for the previous year is less than $10 million.

**ANALYSIS** The required reduction would be calculated as follows:

[($500,000/$500,000)][(5)($50,000 - $50,000)] = Nil

This would leave the company's annual business limit at $500,000.

12-117. Alternatively, for every dollar of ADJUSTED Aggregate Investment Income in excess of $50,000, the company's annual business limit will be reduced by $5.

**EXAMPLE** Before the grind, Arc Ltd. has an annual business limit of $500,000 and ADJUSTED Aggregate Investment Income for the previous year of $75,000. Its TCEC for the previous year is less than $10 million.

**ANALYSIS** The required reduction would be calculated as follows:

[($500,000/$500,000)][(5)($75,000 - $50,000)] = $125,000 **Reduction**

This would leave an annual business limit of $375,000 ($500,000 - $125,000).

## Exercise Twelve - 9

**Subject:** ADJUSTED Aggregate Investment Income Grind

Investco Ltd. is a Canadian controlled private corporation. For the fiscal year ending December 31, 2019, its Net Income For Tax Purposes and Taxable Income is made up of active business income of $350,000, plus ADJUSTED Aggregate Investment Income of $125,000. For 2018, its ADJUSTED Aggregate Investment Income was $105,000. Its TCEC was $9 million for 2019 and $8 million for 2018. Because of its association with Subco Ltd., its 2019 allocation of the annual business limit is $300,000. Subco's TCEC was $200,000 for 2019 and for 2018. Subco has no ADJUSTED Aggregate Investment Income in either year.

Determine the amount of Investco's small business deduction for the year ending December 31, 2019.

**SOLUTION available in print and online Study Guide.**

### Economic Impact

12-118. As indicated previously, the actual reduction in the annual business limit will be the greater of the TCEC grind and the ADJUSTED Aggregate Investment Income grind. With respect to the TCEC grind, it will only have an effect on CCPCs that have TCEC in excess of $10 million. This means that the great majority of CCPCs would not be affected.

12-119. With respect to the new ADJUSTED Aggregate Investment Income grind, in its notes to the new legislation, the Department Of Finance has indicated their belief that only about 3 percent of the companies claiming the small business deduction will be affected.

12-120. Even in those situations where there is a reduction in the annual business limit, this may have no impact on the company's small business deduction. There are many CCPCs that do not have sufficient active business income to fully use their annual business limit. In such situations, the application of these grinds will only increase Tax Payable in those situations where the annual business limit is reduced below the CCPC's active business income.

## Exercise Twelve - 10

**Subject:** Annual Business Limit Reduction

Reduco Inc. is a Canadian controlled private corporation. For the fiscal year ending December 31, 2019, its Net Income For Tax Purposes of $540,000 is made up of active business income of $450,000 and $90,000 of ADJUSTED Aggregate Investment Income. For 2018, the Reduco's ADJUSTED Aggregate Investment Income was $72,000. Its only deduction in the determination of 2019 Taxable Income is a non-capital loss carry forward of $60,000. Because of its association with another company, Reduco's share of the annual business limit is $350,000. The associated company has no ADJUSTED Aggregate Investment Income for either 2018 or 2019.

Determine Reduco's small business deduction for the year ending December 31, 2019, assuming that the combined TCEC of Reduco and its associated company was:

**Case 1** $11,000,000 for 2019 and $13,500,000 for 2018.

**Case 2** $13,500,000 for 2019 and $11,000,000 for 2018.

**SOLUTION available in print and online Study Guide.**

## Personal Services Corporations

12-121. The small business deduction represents a very significant reduction in corporate taxes and, as a consequence, taxpayers have a strong incentive to channel income into a corporation qualifying for this benefit.

12-122. At one point in time, this could be accomplished by having an executive of a corporation resign, establish a company, and immediately have his company sign a contract with his former employer to provide the same services as the individual was previously performing as an employee. Since this new corporation could then qualify for the small business deduction, the use of such personal services corporations provided significant tax deferral and, in some cases, significant tax avoidance, for individuals such as executives, professional athletes, and entertainers.

12-123. Under the current rules, such blatant tax avoidance schemes are no longer possible. To begin, ITA 125(7) defines a "personal services business" as follows:

> ... a business of providing services where
>
> (a) an individual who performs services on behalf of the corporation (referred to as an incorporated employee), or
> (b) any person related to the incorporated employee
>
> is a specified shareholder of the corporation and the incorporated employee would reasonably be regarded as an officer or employee of the person or partnership to whom or to which the services were provided but for the existence of the corporation, unless
>
> (c) the corporation employs in the business throughout the year more than five full-time employees, or
> (d) the amount paid or payable to the corporation in the year for the services is received or receivable by it from a corporation with which it was associated in the year.

12-124. In less technical language, a corporation is classified as a personal services business when a "specified shareholder", or a person related to a "specified shareholder", is providing services to another business and the individual who is performing the services can reasonably be regarded as an officer or employee of the entity for which the services are performed. As the term is used in this definition, in general, "specified shareholder" refers to an individual who owns, directly or indirectly, not less than 10 percent of the shares of any class of the corporation that is providing the services.

12-125. Being classified as a personal services corporation is costly in terms of tax. Such a corporation is not eligible for the small business deduction or the general rate reduction. In addition, due to the fact that the maximum individual federal rate is 33 percent, these corporations are subject to an additional tax of 5 percent, resulting in an overall federal rate of 33 percent (38% - 10% + 5%) which is equal to the maximum individual federal rate.

12-126. In addition to this high rate, personal services corporations cannot deduct any expenses other than:

- salaries, wages, other remuneration, and benefits paid in the year to the individual who performed the services on behalf of the corporation; and
- other expenses that would normally be deductible against employment income, for example, travel expenses incurred to earn employment income.

12-127. These rules serve to make the use of a personal services corporation undesirable in situations where they were once used to save taxes on an executive's employment income. However, athletes, entertainers and consultants may still find it attractive to incorporate. In many cases, they will qualify for the small business deduction either because they have sufficient diversity of income, or more than five full-time employees. In addition, there is an advantage in that all of the income of a personal services business is added to the GRIP balance (see Chapter 13), meaning that all of the income can be paid out as eligible dividends.

## Professional Corporations And Management Companies

12-128. In general terms, these two types of corporations can be described as follows:

> **Professional Corporations** This term is used where a corporation is established to carry on the practice of a profession specified in ITA 248(1). The ITA definition includes a corporation that carries on the professional practice of an accountant, dentist, lawyer, medical doctor, veterinarian, or chiropractor. Each province has different laws and rules as to which professions are allowed to incorporate. The incorporation of the professional practice of an engineer or architect would not meet the ITA definition.
>
> **Management Companies** This is a term that refers to corporations established to provide various management services, primarily to an unincorporated business. The unincorporated business is usually a professional practice, such as that of a doctor or dentist.
>
> The services provided by this type of company include various personnel functions, such as payroll and accounting services, purchasing all supplies and equipment necessary to carry on the business, and providing the necessary office space required by the professional practice.
>
> The unincorporated business pays fees to the company to cover the cost of providing management services and to provide for some income. A 15 percent markup for profit is usually allowed. The fees paid are deductible from the revenues of the professional practice. These companies are often used to transfer a portion of a professional's income to a lower income spouse or other related parties.

12-129. Both types of companies are eligible for the small business deduction. However, the fact that medical services are exempt goods under the GST/HST legislation has made management companies unattractive for doctors and dentists. While GST/HST must be paid on services billed by the management company, these amounts cannot be recovered by medical professionals because their services are GST/HST exempt. (For coverage of GST/HST exempt services, see Chapter 21, GST/HST.) Given this situation, and the fact that professionals can incorporate, management companies for medical professionals delivering GST/HST exempt services are not as common as they once were.

# Manufacturing And Processing Profits Deduction

## Introduction

12-130. Given the importance of such activity to the Canadian economy, it is not surprising that the federal government has provided tax assistance to enterprises that are involved in manufacturing and processing (M&P). As an example of this, in Chapter 5, Capital Cost Allowances, we noted that the government is providing significantly enhanced CCA rates on both buildings used for M&P and for M&P machinery and equipment.

12-131. A more general incentive is the M&P deduction available to some corporations for their M&P profits. IT Folio S4-F15-C1, "Manufacturing and Processing", discusses the calculation of this deduction and activities that are and are not considered to be manufacturing or processing.

12-132. As was explained previously, the rate for this deduction is the same as the percentage for the general rate reduction. Since the general rate reduction does not apply to income that is eligible for the M&P deduction, the use of the M&P deduction does not provide any direct tax benefits at the federal level. Given this situation, it would seem logical for the government to eliminate the complex legislation related to the M&P deduction. However, this has not happened. The probable explanation for this is that two provinces, Ontario and Saskatchewan, provide special treatment for income that qualifies for the federal M&P deduction. Because of this, and the special CCA rates for M&P assets, we will continue to provide some coverage of the M&P rules.

## Calculating The Deduction

### General Formula

12-133. ITA 125.1 provides for a deduction from Tax Payable equal to the general rate reduction of 13 percent, times the company's M&P profits. Given that this amount is deducted from Tax Payable, it would be more consistent to refer to this "deduction" as a tax credit. However, ITA 125.1 uses the term deduction and, as a consequence, we will also use this terminology.

12-134. While the basic idea is that the deduction is equal to the general rate reduction percentage applied to M&P profits, there are a number of other constraints on the amount that is eligible for this deduction. ITA 125.1(1) specifies that the deduction will be equal to the corporation's general rate reduction percentage multiplied by the lesser of:

A. Manufacturing and processing profits, less amounts eligible for the small business deduction; and

B. Taxable income, less the sum of:

   1. the amount eligible for the small business deduction;

   2. the relevant factor (see note) multiplied by the foreign tax credit for business income calculated without consideration of the general rate reduction under ITA 123.4; and

   3. where the corporation is a Canadian controlled private corporation throughout the year, Aggregate Investment Income as defined in ITA 129(4).

**Note** The relevant factor is the same for both the small business deduction and the M&P deduction. While this is a simplification, we will use 4 as the relevant factor in our examples and problems (see Paragraph 12-91 for an explanation).

12-135. Part A of this formula provides the basic limit based on the amount of M&P profits earned during the year. As will be noted subsequently, M&P profits is a technical term and must be calculated by a formula established in ITR 5200. In many cases, particularly for large public companies, this will be the factor that limits the amount of the M&P deduction.

12-136. Like the small business deduction formula, for ease of reference, this M&P deduction formula is included at the front of this text in "Rates and Other Data".

### Constraints - Small Business Deduction

12-137. As was previously discussed, the small business deduction provides certain corporations with a deduction equal to 19 percent of the first $500,000 of their active business income. It appears that the government believes that granting both the 13 percent M&P deduction, and the 19 percent small business deduction on the same income stream would be too generous. As a consequence, any amounts of income that are eligible for the small business deduction are not eligible for the M&P deduction. In the preceding ITA 125.1(1) formula, this is accomplished by removing amounts eligible for the small business deduction from both the A and B components. Note that it is the "amount eligible" for the small business deduction that is removed, not the deduction itself.

### Constraints - Taxable Income

12-138. As was explained in our discussion of constraints on the availability of the small business deduction, the government wants to ensure that credits are not given on amounts that are not included in Taxable Income. As was the case with the active business income that is eligible for the small business deduction, M&P profits that are included in Net Income For Tax Purposes may not find their way into Taxable Income.

12-139. This can occur when the corporation has deductions for such items as charitable donations, non-capital loss carry overs, or farm loss carry overs. For reasons that were discussed and illustrated in the discussion of the small business deduction, amounts eligible for the M&P deduction are limited by the amount of Taxable Income for the year.

### Constraints - Foreign Tax Credits

12-140. As was the case with the Taxable Income constraint, the nature of the constraint created by deducting a multiple of foreign tax credits was explained in our discussion of the small business deduction. There is, however, one significant difference.

12-141. In the ITA 125.1(1) formula for the M&P deduction, Taxable Income is reduced by a multiple of the foreign business income credit only. It is not adjusted for the foreign non-business income credit as was the case with the ITA 125(1) formula for the small business deduction. This probably reflects the fact that the M&P formula contains an extra deduction from Taxable Income for Aggregate Investment Income, an amount that includes foreign non-business income.

### Constraints - Aggregate Investment Income

12-142. This constraint is more difficult to explain at this stage of the text. It is based on the fact that part of the federal tax paid on the Aggregate Investment Income of a Canadian controlled private corporation can be refunded to the corporation (this procedure is discussed in detail in Chapter 13.) As it would not be appropriate to provide a tax credit against taxes that are intended to be refunded, these amounts are removed from the Taxable Income that is eligible for the M&P deduction.

12-143. In the formula in Paragraph 12-134, note the reference to "Aggregate Investment Income as defined in ITA 129(4)". As discussed fully in Chapter 13, Taxation Of Corporate Investment Income, this somewhat unusual concept of investment income is defined as follows:

| | |
|---|---|
| Net Taxable Capital Gains | $xxx |
| Property Income (Including Foreign Source) | |
| Interest (That Is Not Active Business Income) | xxx |
| Rents | xxx |
| Royalties | xxx |
| Total Positive Amounts | $xxx |
| Net Capital Loss Carry Overs Deducted During The Year | ( xxx) |
| ITA 129(4) Aggregate Investment Income | $xxx |

Note that, in contrast to the usual concept of investment income, this definition does not include most dividends. Technically only dividends that are deductible in computing a corporation's Taxable Income are excluded. This calculation is included at the front of this text in "Rates and Other Data".

Also note that this definition is different from the ADJUSTED Aggregate Investment Income that is used in calculating the ADJUSTED Aggregate Investment Income grind on the annual business limit for the small business deduction.

## Eligibility

12-144. On the surface, eligibility for the M&P deduction appears to be easily determinable. Any corporation that derives 10 percent or more of its Canadian active business gross revenues from Canadian manufacturing or processing is eligible. The problem with this rule is the determination of what constitutes M&P activity.

12-145. The *Income Tax Act* does not define the terms manufacturing or processing. However, ITA 125.1(3) specifically excludes several types of activity from the designation of manufacturing or processing. These include logging, farming and fishing, construction, producing industrial minerals, and processing mineral resources.

## M&P Profits Defined

12-146. We have noted that the M&P deduction is calculated by multiplying the general rate reduction percentage by "M&P profits". The determination of M&P profits is based on a

fairly complex calculation that is found in ITR 5200. Given that this is largely a mechanical process and the fact that the M&P deduction no longer has an effect on the amount of federal Tax Payable, we are not providing coverage of this calculation in our text.

**Exercise Twelve - 11**

**Subject:** Amounts Eligible For Small Business and M&P Deductions

Marion Manufacturing is a Canadian controlled private corporation throughout 2019 and is not associated with any other company. It has Net Income For Tax Purposes of $462,000, a figure that includes $411,000 in manufacturing and processing profits (as per ITR 5200). The $462,000 also includes foreign source business income of $21,000 and taxable capital gains of $30,000. Because of withholding on the foreign source business income, the Company is entitled to a foreign tax credit of $3,150 [(15%)($21,000)].

The Company's only deduction in the calculation of Taxable Income is donations to registered Canadian charities in the amount of $310,000. Marion anticipates large increases in Taxable Income in the next few years.

Determine the amount of Marion's small business deduction and M&P deduction for the year ending December 31, 2019, assuming that the Company deducts all of the $310,000 of charitable donations. Do you believe that deducting all of the donations is the best alternative for Marion? Explain your conclusion.

**SOLUTION available in print and online Study Guide.**

# General Rate Reduction - ITA 123.4(2)

## Approach To Rate Reductions

12-147. In our discussion of the basic federal tax rate for corporations, we noted that, in implementing reductions in corporate tax rates, the government has left the basic rate of 38 percent unchanged (see Paragraph 12-45). Instead of reducing the basic rate, they have created a deduction from this rate. This deduction is referred to as the "general rate reduction" percentage and the rate is currently 13 percent.

12-148. While the government wished to reduce corporate tax rates through the use of this general rate reduction, they did not want it to be available on income that was already benefitting from some other tax privilege (e.g., the small business deduction). To deal with this potential problem, the government introduced the concept of Full Rate Taxable Income.

## Full Rate Taxable Income

12-149. In defining Full Rate Taxable Income, the goal was to develop a measure of income that did not benefit in a significant way from other legislative provisions. In particular, the government did not want this reduction to be applied to income that was eligible for:

- The small business deduction. This deduction is only available to CCPCs.
- The M&P deduction. This deduction is available to CCPCs, public companies, and private companies that are not Canadian controlled.
- Refundable Taxes. Refundable taxes are applicable to the investment income of CCPCs and, in some applications to the investment income of private companies that are not Canadian controlled. They are not applicable to public companies. While we need to consider the impact of refundable taxes on Full Rate Taxable Income at this point, detailed procedures related to refundable taxes are discussed in Chapter 13.

12-150. Since the availability of the relevant benefits depends on the type of company, we

will have to give separate attention to the calculation of the Full Rate Taxable Income of CCPCs, and to the Full Rate Taxable Income of companies that are not CCPCs (public companies and private companies that are not Canadian controlled).

## Application To Companies Other Than CCPCs

12-151. For these companies, the only adjustment to Taxable Income that is required to determine Full Rate Taxable Income is the removal of income eligible for the M&P deduction. Given this, for companies other than CCPCs, Full Rate Taxable Income is defined as follows:

| | |
|---|---|
| Regular Taxable Income | $x,xxx |
| Income Eligible For The M&P Deduction | ( xxx) |
| Full Rate Taxable Income | $x,xxx |

12-152. A simple example will serve to illustrate the relevant calculations:

**EXAMPLE** For the year ending December 31, 2019, Daren Ltd., a Canadian public company, has Taxable Income equal to $100,000, with $40,000 of this amount eligible for the M&P deduction.

**ANALYSIS** Full Rate Taxable Income is equal to $60,000 ($100,000 - $40,000). Given this, total federal Tax Payable for Daren Ltd. would be calculated as follows:

| | |
|---|---|
| Base Amount Of Part I Tax [(38%)($100,000)] | $38,000 |
| Federal Tax Abatement [(10%)($100,000)] | ( 10,000) |
| M&P Deduction [(13%)($40,000)] | ( 5,200) |
| General Rate Reduction [(13%)($100,000 - $40,000)] | ( 7,800) |
| Federal Tax Payable | $15,000 |

12-153. For a corporation with income consisting entirely of M&P profits, there is no general rate reduction as there is no Full Rate Taxable Income. This is illustrated by revising the example in Paragraph 12-152:

**EXAMPLE - Revised** Assume that the $100,000 in Taxable Income of Daren Ltd. was generated solely by M&P activities.

**ANALYSIS** Total federal Tax Payable for Daren Ltd. would be calculated as follows:

| | |
|---|---|
| Base Amount Of Part I Tax [(38%)($100,000)] | $38,000 |
| Federal Tax Abatement [(10%)($100,000)] | ( 10,000) |
| M&P Deduction [(13%)($100,000)] | ( 13,000) |
| General Rate Reduction [(13%)($100,000 - $100,000)] | Nil |
| Federal Tax Payable | $15,000 |

12-154. This calculation illustrates the fact that the overall federal rate on income that is eligible for the M&P deduction is 15 percent. This is, of course, identical to the overall rate on income that is eligible for the general rate reduction, illustrating the fact that the M&P deduction is not advantageous at the federal level.

### Exercise Twelve - 12

**Subject:** Federal Tax Payable For A Public Company

For the year ending December 31, 2019, Marchand Inc., a Canadian public company, has Taxable Income of $320,000. Of this total, $180,000 qualifies for the M&P deduction. Calculate Marchand's federal Tax Payable for the year ending December 31, 2019. Include in your solution any M&P deduction available.

**SOLUTION available in print and online Study Guide.**

## Application To CCPCs

12-155. Not surprisingly, the calculation of Full Rate Taxable Income for a CCPC is somewhat more complex than it is for a public company. As we have noted, in addition to the M&P deduction, these companies may benefit from the small business deduction and the refundable tax provisions on investment income.

12-156. Given the potential presence of these additional tax privileges, Full Rate Taxable Income for a CCPC is defined as follows:

Taxable Income, reduced by:

1. Income eligible for the small business deduction.
2. Income eligible for the M&P deduction.
3. The corporation's Aggregate Investment Income for the year as defined in ITA 129(4). [This is to remove income that will benefit from refundable taxes when it is distributed by the corporation. These taxes are explained in Chapter 13.]

12-157. The definition of Aggregate Investment Income in ITA 129(4) was discussed in the coverage of the M&P deduction (see Paragraph 12-143). It includes both foreign and Canadian amounts of net taxable capital gains, interest, rents, and royalties, but not dividends that are deductible in computing Taxable Income. The balance is reduced by net capital loss carry overs deducted during the year.

12-158. As is covered in Chapter 13, a portion of the Part I tax paid by CCPCs on their Aggregate Investment Income is refunded when dividends are paid. Because of this refund, Aggregate Investment Income is already taxed advantageously when it is flowed through a CCPC. Given this, it does not receive the benefit of the general rate reduction.

12-159. The following example illustrates the application of the general rate reduction rules to a CCPC with no investment income.

**EXAMPLE** For the year ending December 31, 2019, Zaptek Ltd., a CCPC, has $200,000 in Taxable Income. This amount is made up entirely of active business income earned in Canada, none of which relates to M&P activity. Zaptek is associated with another company and, as per the agreement with that company, Zaptek is entitled to $100,000 of the annual business limit.

**ANALYSIS** The federal Tax Payable for Zaptek Ltd. would be calculated as follows:

| | |
|---|---|
| Base Amount Of Part I Tax [(38%)($200,000)] | $76,000 |
| Federal Tax Abatement [(10%)($200,000)] | ( 20,000) |
| Small Business Deduction [(19%)($100,000)] | ( 19,000) |
| General Rate Reduction [(13%)($200,000 - $100,000)] | ( 13,000) |
| Federal Tax Payable | $24,000 |

12-160. The overall rate of federal tax in this example is 12 percent ($24,000 ÷ $200,000). This reflects a combination of a rate of 9% (38% - 10% - 19%) on the $100,000 of income that was eligible for the small business deduction, and a rate of 15% (38% - 10% - 13%) on income that was not eligible for this deduction.

## Exercise Twelve - 13

**Subject:** Federal Tax Payable For A CCPC

Redux Ltd. is a Canadian controlled private corporation. For the year ending December 31, 2019, the Company has Taxable Income of $200,000, all of which is active business income. Of this amount, $145,000 results from M&P activity. As it is associated with two other corporations, its share of the annual business limit is $140,000. Determine the Company's federal Tax Payable for the year ending December 31, 2019. Include in your solution any M&P deduction available.

**SOLUTION available in print and online Study Guide.**

**We suggest you work Self Study Problems Twelve-6, 7, 8, and 9 at this point.**

# Foreign Tax Credits For Corporations

## Introduction

12-161. The foreign tax credits that are available to individuals earning foreign business or non-business income are discussed in detail in Chapter 11. Under rules that are very similar to those applicable to individuals, corporations are also allowed to use foreign taxes paid on business and non-business income as credits against Canadian Tax Payable. While the rules are similar to those for individuals, there are differences that will be discussed here. IT Folio S5-F2-C1, "Foreign Tax Credit" gives interpretations with respect to some of the most commonly encountered requirements contained in these foreign tax credit provisions.

## Calculation Of Foreign Tax Credits

### *Foreign Non-Business (Property) And Business Tax Credits*

12-162. The formula that limits the Canadian tax credit for foreign taxes paid on foreign source non-business income is as follows:

The **Foreign NON-BUSINESS Income Tax Credit** is the lesser of:

- The tax paid to the foreign government (for corporations, there is no 15 percent limit on the foreign non-business taxes paid by a corporation)
- An amount determined by the following formula:

$$\left[\frac{\text{Foreign } \textbf{NON - BUSINESS} \text{ Income}}{\text{Adjusted Division B Income}}\right] [\text{Tax Otherwise Payable}]$$

12-163. The meaning of "Adjusted Division B Income" and "Tax Otherwise Payable" are explained beginning at Paragraph 12-166. Both of the foreign tax credit formulae are included at the front of this text in "Rates and Other Data".

12-164. The formula that limits the amount of foreign business income taxes paid that can be used as a foreign tax credit is as follows:

The **Foreign BUSINESS Income Tax Credit** is the least of:

- The tax paid to the foreign government
- An amount determined by the following formula:

$$\left[\frac{\text{Foreign } \textbf{BUSINESS} \text{ Income}}{\text{Adjusted Division B Income}}\right] [\text{Tax Otherwise Payable}]$$

- Tax Otherwise Payable for the year, less any foreign tax credit taken on non-business income under ITA 126(1).

12-165. As was the case with individuals, there is an additional factor to consider in the case of foreign business income tax credits. This is the "Tax Otherwise Payable", reduced by any foreign non-business income tax credit deducted under ITA 126(1).

### Adjusted Division B Income

12-166. While the general descriptions in the formulae (e.g., Adjusted Division B Income and Tax Otherwise Payable) are the same as those applicable to individuals, their meaning is somewhat different. More specifically, for a corporation, "Adjusted Division B Income" is determined as follows:

| | |
|---|---|
| Division B Income (Net Income For Tax Purposes) | $x,xxx |
| Net Capital Loss Carry Overs Deducted Under ITA 111(1)(b) | ( xxx) |
| Taxable Dividends Deducted Under ITA 112 | ( xxx) |
| Dividends From A Foreign Affiliate Deductible Under ITA 113 | ( xxx) |
| Adjusted Division B Income | $x,xxx |

### Tax Otherwise Payable

12-167. The following table compares the components included in the calculation of Tax Otherwise Payable for foreign non-business tax credits with those used to calculate foreign business tax credits.

| Tax Otherwise Payable Components | Non-Business | Business |
|---|---|---|
| Base Amount Of Part I Tax (38%) | Yes | Yes |
| Plus: Additional Refundable Tax (ART) On Investment Income Of CCPC (See Chapter 13) | Yes | No |
| Minus: Federal Tax Abatement | Yes | No |
| Minus: General Rate Reduction | Yes | Yes |

12-168. "Tax Otherwise Payable" is a particularly confusing term as its calculation is different for individuals and corporations. As shown in the table, adding to the confusion is the fact that its components differ depending on whether it is being used to calculate foreign non-business tax credits or foreign business tax credits for corporations.

12-169. You will recall that the purpose of the 10 percent federal tax abatement is to leave room for the provinces to tax corporations. It is deducted in the formula for determining foreign non-business tax credits because non-business income will, in general, be taxed in a province. As a consequence, it is appropriate to deduct this abatement in determining the limit on the foreign non-business tax credit.

12-170. In contrast, in the calculation of the foreign business income tax credit, "Tax Otherwise Payable" is not reduced by the 10 percent federal tax abatement, reflecting the fact that foreign business income will not be taxed in a province. Also different is the fact that this calculation of "Tax Otherwise Payable" does not include the additional refundable tax on investment income under ITA 123.3. (See Chapter 13.)

12-171. You may recall that the foreign tax credit constraint in the small business deduction calculation uses foreign tax credit amounts that do not consider the general rate reduction (see Paragraph 12-98). The reason for this is a potentially circular calculation. Since the general rate reduction amount uses the amount eligible for the small business deduction and the small business deduction calculation uses the foreign tax credits, these amounts cannot all be calculated at the same time. As a result, the foreign tax credits used in calculating the small business deduction may not be equal to the actual foreign tax credits.

### Foreign Tax Credit Carry Overs

12-172. Unlike the situation with individuals, where the amount of foreign taxes that can be used as a credit is limited to 15 percent of the foreign source non-business income, the only limit for a corporation is the limit that is found in the second component of the formula. If the actual amount of foreign taxes paid is greater than this limit, there is no carry over of the excess

as a tax credit. However, as was noted in Chapter 11, unclaimed amounts can be deducted under ITA 20(12) in the determination of Net Income For Tax Purposes.

12-173. Unlike the case with foreign non-business income taxes paid in excess of amounts used as tax credits, unused foreign business taxes paid can be carried over as a tax credit to the 3 preceding taxation years or the 10 subsequent taxation years. In calculating the allowable tax credit for such carry overs, these unused amounts will be added to the foreign tax paid factor in the calculation of the foreign business income tax credit.

**Exercise Twelve - 14**

**Subject:** Foreign Tax Credits

Internat Inc. is a Canadian public company. For the year ending December 31, 2019, it has Net Income For Tax Purposes of $146,000, including foreign business income of $20,000. The foreign government withheld $3,000 in taxes on this income, resulting in a net remittance of $17,000. None of the Company's income involves manufacturing and processing and, based on the ITR 402(3) formula, 88 percent of the Company's income was allocated to a province. In calculating Taxable Income, the Company deducts $30,000 in dividends received from taxable Canadian companies, a non-capital loss carry forward of $75,000, and a net capital loss carry forward of $25,000. Determine the Company's Part I Tax Payable for the year ending December 31, 2019. Include in your answer any carry overs available at the end of the year.

**SOLUTION available in print and online Study Guide.**

**We suggest you work Self Study Problem Twelve-10 at this point.**

# Refundable Journalism Labour Tax Credit

## Described

12-174. The March 29, 2019 budget introduced three provisions designed to encourage Canadian journalism organizations.

- A 25 percent refundable credit for salaries and wages paid to Eligible Newsroom Employees of a Qualifying Canadian Journalism Organizations. This credit is available for expenditures made after January 1, 2019.
- A non-refundable credit for individuals based on the cost of their subscriptions to digital news services. This credit is not available until 2020.
- A provision that allows some journalism organizations to register as qualified donees able to issue tax receipts for donations. These provisions are not applicable until 2020.

12-175. The 25 percent credit is capped at $55,000 for each Eligible Newsroom Employee, providing a maximum credit of $13,750 [(25%)($$55,000)] for each such employee. The base for the credit will be reduced by any financial assistance received during the year from any level of government.

12-176. It appears that, even though journalism organizations that qualify as registered donees do not pay income taxes, they will be eligible for this refundable credit.

## Definitions - ITA 125.6

12-177. As usual, the application of this credit requires an understanding of some technical definitions. These are as follows:

**Qualifying Canadian Journalism Organization** To qualify, the organization must meet the following conditions:

- it must be primarily engaged in the production of written news content;
- it must not be carrying on a broadcasting operation;
- it does not receive any amount from the Canada Periodical Fund; and
    - if it is a public corporation, its shares must be listed on a designated stock exchange in Canada; or
    - if it is not publicly traded, at least 75 percent of its shares must owned by Canadian citizens or a publicly traded qualifying journalism organization.

**Eligible Newsroom Employee** This means an individual who:

- is employed by a Qualifying Canadian Journalism Organization;
- works a minimum of 26 hours per week throughout the portion of the taxation year in which the individual is employed;
- is employed for a minimum period of 40 consecutive weeks; and
- spends at least 75% of their time engaged in the production of news content, including researching, collecting information, verifying facts, photographing, writing, editing, designing and otherwise preparing content.

**Additional Supplementary Self Study Problems Are Available Online.**

# Key Terms Used In This Chapter

12-178. The following is a list of the key terms used in this Chapter. These terms, and their meanings, are compiled in the Glossary located at the back of the Study Guide.

Active Business
Active Business Income
Adjusted Active Business Income
ADJUSTED Aggregate Investment Income
Allowable Business Investment Loss
Allowable Capital Loss
Annual Business Limit
Associated Corporations
Business Income
Business Investment Loss
Canadian Controlled Private Corporation
Carry Over
CCPC
Common Shares
Corporation
Designated Stock Exchange
Disposition
Eligible Newsroom Employee
Federal Tax Abatement
Foreign Taxes Paid Credit
Full Rate Taxable Income
GAAP
General Rate Reduction
Grind
Loss Carry Back
Loss Carry Forward
Manufacturing And Processing Profits Deduction (M&P Deduction)
Net Business Income
Net Capital Loss
Non-Capital Loss
Ordering Rule
Permanent Establishment
Personal Services Business
Preferred Shares
Private Corporation
Professional Corporation
Property Income
Public Corporation
Qualifying Canadian Journalism Organization
Refundable Journalism Labour Tax Credit
Small Business Deduction
Specified Investment Business
Stop Loss Rules
Taxable Capital Employed In Canada
Term Preferred Shares

# References

12-179. For more detailed study of the material in this Chapter, we refer you to the following:

| | |
|---|---|
| ITA 89(1) | Definitions (Private Corporation And Public Corporation) |
| ITA 110 | Deductions Permitted |
| ITA 111 | Losses Deductible |
| ITA 112 | Deduction Of Taxable Dividends Received By Corporations Resident In Canada |
| ITA 113 | Deduction In Respect Of Dividend Received From Foreign Affiliate |
| ITA 123 | Basic Part I Rate For Corporations |
| ITA 123.3 | Additional Refundable Tax On CCPC's Investment Income |
| ITA 123.4(2) | General Deduction From Tax |
| ITA 124 | Federal Abatement |
| ITA 125 | Small Business Deduction |
| ITA 125.1(1) | Manufacturing And Processing Profits Deductions |
| | |
| S3-F8-C1 | Principal Business Corporation In The Resource Industries |
| S4-F15-C1 | Manufacturing And Processing |
| S5-F2-C1 | Foreign Tax Credit |
| | |
| IT-67R3 | Taxable Dividends From Corporations Resident In Canada |
| IT-73R6 | The Small Business Deduction |
| IT-177R2 | Permanent Establishment Of A Corporation In A Province (Consolidated) |
| IT-189R2 | Corporations Used By Practising Members Of Professions |
| IT-206R | Separate Businesses |
| IT-232R3 | Losses — Their Deductibility In The Loss Year Or In Other Years |
| IT-391R | Status Of Corporations |
| IT-458R2 | Canadian Controlled Private Corporation |

# Problems For Self Study (Online)

To provide practice in problem solving, there are Self Study and Supplementary Self Study problems available on MyLab Accounting.

Within the text we have provided an indication of when it would be appropriate to work each Self Study problem. The detailed solutions for Self Study problems can be found in the print and online Study Guide.

We provide the Supplementary Self Study problems for those who would like additional practice in problem solving. The detailed solutions for the Supplementary Self Study problems are available online, not in the Study Guide.

The .PDF file "Self Study Problems for Volume 2" on MyLab contains the following for Chapter 12:

- 10 Self Study problems,
- 5 Supplementary Self Study problems, and
- detailed solutions for the Supplementary Self Study problems.

# Assignment Problems

(The solutions for these problems are only available in the solutions manual that has been provided to your instructor.)

### *Assignment Problem Twelve - 1*

***(Corporate Taxable Income)***

The Income Statement that has been prepared by Margo Ltd.'s accountant for the year ending December 31, 2019, is as follows:

| | | |
|---|---|---|
| Sales Revenue | | $925,000 |
| Cost Of Goods Sold (Note 1) | | ( 717,000) |
| Gross Profit | | $208,000 |
| Operating Expenses: | | |
| Salaries And Wages | ($40,200) | |
| Rents | ( 22,200) | |
| Property Taxes (Note 2) | ( 8,800) | |
| Amortization Expense | ( 35,600) | |
| Write-Down Of Goodwill (Note 3) | ( 1,700) | |
| Charitable Donations | ( 19,800) | |
| Legal Fees (Note 4) | ( 2,220) | |
| Bad Debt Expense (Note 5) | ( 7,100) | |
| Warranty Provision (Note 6) | ( 5,500) | |
| Social Club Membership Fees | ( 7,210) | |
| Other Operating Expenses | ( 39,870) | ( 190,200) |
| Operating Income | | $ 17,800 |
| Other Revenues (Expenses): | | |
| Gain On Sale Of Investments (Note 7) | $9,500 | |
| Interest Revenue | 2,110 | |
| Interest On Late Income Tax Instalments | ( 1,020) | |
| Investment Counsellor Fees | ( 500) | |
| Foreign Interest Income (Note 8) | 1,530 | |
| Dividends From Taxable Canadian Corporations | 3,000 | 14,620 |
| Income Before Taxes | | $ 32,420 |

**Notes And Other Information:**

1. The calculation of Cost Of Goods Sold was based on an opening inventory of $225,000 and a closing inventory of $198,600. In addition, the closing inventory was reduced by $15,000 for a reserve for future declines in value. This is the first year the Company has used an inventory reserve.
2. Property Taxes include $1,200 for tax paid on vacant land. The company has held this land for 5 years, in anticipation of relocating its head office.
3. As the result of a business combination on January 15, 2019, Margo Ltd. recorded $34,000 in goodwill. As of December 31, 2019, this goodwill was found to be impaired and a goodwill impairment loss of $1,700 was recorded.
4. The maximum CCA for the current year is $79,785. This includes the appropriate write-off of the goodwill described in Item 3.
5. The legal fees are made up of $1,200 paid to appeal an income tax assessment and $1,020 paid for general corporate matters.
6. The Company bases its accounting Bad Debt Expense on the values used for tax purposes.
7. This is the first year that the Company has deducted a provision for estimated warranties.
8. The gain on the sale of investments involved marketable securities with a cost of $21,000. The securities were sold for $30,500.
9. The gross foreign interest income of $1,800 was received net of $270 in foreign tax withholdings.

**Required:** Determine the minimum Net Income For Tax Purposes and Taxable Income of Margo Ltd., for the year ending December 31, 2019.

## *Assignment Problem Twelve - 2*

### *(Corporate Taxable Income)*

Cabrera Digital is a Canadian public company. It has always used a taxation year that ends on December 31. During the year ending December 31, 2019, it had operating revenues of $1,234,000 and operating expenses of $962,000, resulting in an operating income $272,000.

Also during 2019, it received the following dividends:

| | |
|---|---|
| • Non-Eligible Dividends From 100 Percent Owned Subsidiary | $23,600 |
| • Eligible Dividends From Canadian Public Companies | 61,300 |

The Company's only other property income was a $312,000 capital gain on a holding of temporary investments. Because of this very fortunate investment result, the Company decides to make a $241,000 donation to a registered Canadian charity. No other capital gains are anticipated in the foreseeable future.

At the beginning of the year ending December 31, 2019, the Company had the following carry forward balances:

| | |
|---|---|
| • Net Capital Losses | $262,000 |
| • Non-Capital Losses | 193,000 |

**Required:** Calculate the minimum Net Income For Tax Purposes and Taxable Income for Cabrera Digital for the year ending December 31, 2019. Indicate the amount and type of any carry forwards that are available at the end of that year.

## *Assignment Problem Twelve - 3*

***(Corporate Net And Taxable Income)***

Vertin Ltd. is a Canadian public company that has always used a December 31 year end. However, as December is a very busy time for their business activities, it has requested a change in their taxation year end to July 31, a date at which their business activity is at the low point for the year. They have presented this situation to the CRA and the Department has accepted their request for the change.

The change will be implemented during 2019, resulting in a short fiscal period ending July 31, 2019. The Company's Income Statement, prepared in accordance with generally accepted accounting principles, for the period January 1, 2019 through July 31, 2019 is as follows:

**Vertin Ltd.**
**Income Statement**
**7 Month Period Ending July 31, 2019**

| | | |
|---|---|---|
| Sales (All Within Canada) | | $1,796,600 |
| Cost Of Sales | | ( 973,400) |
| Gross Margin | | $ 823,200 |
| Other Expenses (Excluding Taxes): | | |
| Wages And Salaries | ($108,200) | |
| Cost Of Sales | ( 194,200) | |
| Amortization | ( 97,600) | |
| Rent | ( 113,400) | |
| Interest Expense | ( 13,200) | |
| Foreign Exchange Loss | ( 7,600) | |
| Travel And Promotion | ( 86,300) | |
| Bad Debt Expense | ( 6,200) | |
| Warranty Expense | ( 7,400) | |
| Charitable Donations | ( 8,100) | |
| Other Operating Expenses | ( 51,200) | ( 693,400) |
| Operating Income | | $ 129,800 |
| Gain On Sale Of Investments | | 7,800 |
| Income Before Taxes | | $ 137,600 |

**Other Information:**

1. Wages and salaries includes a $28,000 bonus to Vertin Ltd.'s CEO. Because she anticipates retiring at the end of 2020, this bonus will not be paid until January, 2021.
2. In determining the Cost Of Sales, the Company deducted a $23,400 reserve for inventory obsolescence.
3. Amortization is on a Class 1 building, Class 8 furniture and fixtures, and Class 10 delivery vehicles. The following information is relevant for the determination of CCA for the 7 month period ending July 31, 2019:

   **Building** The January 1, 2019 UCC for the building was $872,000. During 2019, the Company spent $42,000 on improved flooring in all areas of the property. The building was not a new building when it was acquired.

   **Furniture And Fixtures** The January 1, 2019 UCC balance for Class 8 was $285,000. During 2019, new furniture was acquired at a cost of $40,600. Old furniture with a capital cost of $28,200 was sold for $17,600.

   **Delivery Vehicles** On January 1, 2019, the Class 10 UCC balance was $198,300. There were no additions or disposals in this Class during the 7 month period ending July 31, 2019.

4. The interest expense relates to a line of credit that was used to finance seasonal fluctuations in inventory.

5. The foreign exchange loss resulted from financing costs related to the purchase of merchandise in the United Kingdom.

6. The travel and promotion expense consisted of the following items:

| | |
|---|---|
| Business Meals And Entertainment | $32,400 |
| Hotels And Airfare | 41,800 |
| Golf Club Memberships | 12,100 |
| Total Travel And Promotion Expense | $86,300 |

7. For accounting purposes, the Company establishes a warranty reserve based on estimated costs. On January 1, 2019, the reserve balance was $8,200. On July 31, 2019, a new reserve was established at $7,400.

8. The accounting gain on the sale of investments is equal to the capital gain for tax purposes.

9. During the period January 1, 2019 through July 31, 2019, the Company declared and paid dividends of $31,400.

10. On January 1, 2019, the Company has available a $24,600 non-capital loss carry forward and a $7,200 [(1/2)($14,400)] net capital loss carry forward.

**Required:** Calculate the minimum Net Income For Tax Purposes and Taxable Income for Vertin Ltd. for the 7 month period ending July 31, 2019. Indicate the amount and type of any carry forwards that will be available for use in future years.

## Assignment Problem Twelve - 4

### (Corporate Loss Carry Forwards)

The following information relates to the operations of Notem Inc. for the taxation year ended December 31, 2019 (all amounts are based on the relevant tax rules):

| | |
|---|---|
| Net Business Loss | $141,800 |
| Dividends From Taxable Canadian Corporations | 33,500 |
| Taxable Capital Gains | 9,600 |
| Allowable Capital Losses | 4,425 |
| Charitable Donations | 5,400 |

At the beginning of the taxation year, the Company had a carry forward of unused charitable donations of $1,350 from the previous year, and a net capital loss carry forward of $10,500 [(1/2)($21,000)].

It is the policy of the Company to minimize net capital loss balances prior to using any other type of carry over balance.

**Required:** Calculate the corporation's minimum Net Income For Tax Purposes and Taxable Income for its 2019 taxation year. Indicate any balances available for carry forward to subsequent years.

## Assignment Problem Twelve - 5

### (Corporate Loss Carry Forwards - 4 Years)

Linden Industries Inc. began operations in 2016 and has a December 31 fiscal year end. While it was fairly successful in its first year of operation, excessive production of an unmarketable product resulted in a large operating loss for 2017. Profits have come back in 2018 and 2019.

The relevant Division B income and loss figures, along with charitable donations made during the years under consideration are as follows:

| | 2016 | 2017 | 2018 | 2019 |
|---|---|---|---|---|
| Business Income (Loss) | $95,000 | ($205,000) | $69,500 | $90,000 |
| Capital Gains (Losses) | ( 10,000) | ( 14,000) | 9,000 | 10,000 |
| Dividends Received | 12,000 | 42,000 | 28,000 | 32,000 |
| Charitable Donations | 21,400 | 4,600 | 8,000 | 22,000 |

All of the dividends have been received from taxable Canadian corporations. It is the policy of the Company to minimize its net capital loss carry forward balance.

**Required:** For each of the four years 2016 through 2019, provide the following information:

- The minimum Net Income For Tax Purposes and Taxable Income that would be reported for Linden Industries. Indicate the amount and type of any current year losses that are available for carry back or carry forward.
- The amended figures for any years to which losses are carried back.
- An analysis of the amount and type of carry forwards that would be available at the end of the year.

### *Assignment Problem Twelve - 6*

### *(Corporate Loss Carry Forwards - 4 Years)*

Metronet Inc. is a Canadian public company with a December 31 year end. It commenced operations in 2016 and has had mixed results since that time. In terms of its business income (loss), the results, determined using the relevant tax legislation, were as follows:

| | 2016 | 2017 | 2018 | 2019 |
|---|---|---|---|---|
| Net Business Income (Loss) | $233,500 | $34,000 | ($163,000) | $57,000 |

**Other Information:**

1. In each of the years 2016 through 2019, Metronet receives dividends from taxable Canadian companies of $13,500.
2. In 2016, Metronet made charitable donations of $4,800, followed by a donation of $15,600 in 2017. The donations declined to $7,400 in 2018. No contributions were made in 2019.
3. In 2016, Metronet realized a capital loss of $24,600, followed by a $45,600 capital gain in 2017. In 2018, there was a capital loss of $48,400. Things improved in 2019, during which Metronet realized a $33,200 capital gain.

It is the policy of the Company to minimize its net capital loss carry forward balance, prior to minimizing other types of carry forwards.

**Required:** For each of the four years 2016 through 2019, provide the following information:

- The minimum Net Income For Tax Purposes and Taxable Income that would be reported for Metronet Inc. Indicate the amount and type of any current year losses that are available for carry back or carry forward.
- The amended figures for any years to which losses are carried back.
- An analysis of the amount and type of carry forwards that would be available at the end of the year.

### Assignment Problem Twelve - 7

#### (Geographical Allocation Of Income)

The Sundean Company has its national headquarters in Toronto, and all of its senior management people have their offices at this location. The Company also has operations in Vancouver, Calgary, Saskatoon, and Halifax. In each of these cities, warehouse space is maintained and orders are filled. In addition, a sales staff operates out of office space in each warehouse, taking orders throughout the province in which the warehouse is located.

For the current taxation year, the Company's Taxable Income totalled $1,546,000, on gross revenues of $10,483,000. Also during the current year, the Company had salaries and wages totalling $1,247,000. These gross revenues and expenses were distributed among the provinces where the Company has operations in the following manner:

| | Gross Revenues | Wages And Salaries Accrued |
|---|---|---|
| Alberta | $ 1,886,940 | $ 261,870 |
| British Columbia | 2,306,260 | 274,340 |
| Nova Scotia | 1,362,790 | 174,580 |
| Saskatchewan | 1,257,960 | 99,760 |
| Ontario | 3,669,050 | 436,450 |
| Total | $10,483,000 | $1,247,000 |

**Required:** Calculate the amount of the Sundean Company's Taxable Income for the current year that would be allocated to each of the five provinces. Any percentages used in your calculations should be rounded to one decimal place.

### Assignment Problem Twelve - 8

#### (Part I Tax With Reduced SBD)

Jordu Inc. is a large Canadian controlled private corporation (CCPC). Gross revenues for 2019 totaled $3,460,000, with 28 percent of this amount generated in Ontario, 63 percent in British Columbia, and the remainder coming from outside of Canada. The revenues were earned in a country where Jordu has a permanent establishment. Wages and salaries for this period totaled $1,250,000, all of which were paid in British Columbia.

Taxable Income for the 2019 tax year was determined to be $1,265,000, with all but $130,000 of this total consisting of Canadian active business income. The $130,000 is foreign business income. The foreign jurisdiction withheld $19,500 in tax, remitting the remaining $110,500 to Jordu.

Jordu is associated with three other companies. The four companies split the annual business limit equally. The combined Taxable Capital Employed in Canada for Jordu and its associated companies is $14,126,384 for 2019. For 2018, the corresponding figure is $13,246,900.

Neither Jordu, nor any of its associated companies, have any Adjusted Aggregate Investment Income for all years under consideration.

Assume that Jordu's tax credit will be equal to the amount of foreign taxes paid.

**Required:** Calculate Jordu's minimum federal Part I Tax Payable for the year ending December 31, 2019.

### Assignment Problem Twelve - 9

#### (Corporate Tax Payable)

For the taxation year ending December 31, 2019, Lorne Inc., a Canadian controlled private company, has Net Income For Tax Purposes of $340,500. This is made up of $312,400 of active business income and $28,100 of dividends from various Canadian public companies. It

has been determined that $211,300 of the active business income qualifies as manufacturing and processing profits.

During 2019, the Company makes donations to registered charities totaling $31,400.

At the beginning of 2019, the Company has a non-capital loss carry forward of $29,300. It intends to deduct all of this carry forward during 2019.

Lorne Inc. is associated with three other CCPCs. The companies have agreed that each company will claim one-quarter of the annual business limit. The combined Taxable Capital Employed In Canada for the four associated companies is less than $10 million in both 2018 and 2019. The combined Adjusted Aggregate Investment Income of the four companies was $45,000 in 2018.

**Required:** Determine the minimum Taxable Income and Part I federal Tax Payable for Lorne Inc. for the year ending December 31, 2019. Show all calculations, whether or not they are necessary to the final solution. As the corporation operates in a province that has a reduced tax rate for M&P activity, a separate calculation of the federal M&P deduction is required.

### *Assignment Problem Twelve - 10*
### *(Comprehensive Corporate Tax Payable)*

For the year ending December 31, 2019, Mamora Ltd. had accounting income before taxes of $1,115,050. Mamora is a Canadian controlled private company throughout 2019.

Other Information related to the Company's 2019 taxation year is as follows:

1. The accounting income figure included a deduction for Amortization Expense of $405,525.
2. On January 1, 2019, Mamora Ltd. had the following UCC balances:

| | |
|---|---|
| Class 1 | $1,050,000 |
| Class 8 | 1,460,000 |
| Class 10 | 142,000 |
| Class 13 | 175,000 |

The Class 1 balance relates to a single building acquired at a cost of $1,650,000. It is estimated that the cost of land included in this amount is $350,000. In June, 2019, this building is sold for $1,725,000, including an estimated value for the land of $375,000. In accounting records this real property was carried at $1,550,000, a net book value for the building of $1,200,000, plus $350,000 for the land. As a result of this sale, a gain of $175,000 was included in the accounting income figure.

The old building is replaced on February 15, 2019 with a new building acquired at a cost of $2,100,000, of which $400,000 is allocated to land. The building is used 95 percent for manufacturing and processing activity and it is allocated to a separate Class 1.

During 2019, Class 8 assets are acquired at a cost of $150,000. There are no dispositions of Class 8 assets during the year.

As the Company has decided to lease all of its vehicles in the future, all of the assets in Class 10 are sold during the year. The capital cost of these assets was $285,000 and the proceeds of disposition amounted to $122,000 with no asset disposed of for more than its capital cost. The net book value of these assets was $185,000, resulting in a loss of $63,000 being included in accounting income.

The Class 13 balance relates to a single lease that commenced on January 1, 2014. The lease has an initial term of 6 years, with an option to renew for 4 years. Expenditures on this leasehold were $250,000 in 2014 and $60,000 in 2018. There were no further expenditures in 2019. The write-off of these expenditures for accounting purposes is included in the Amortization Expense figure that was deducted in the determination of accounting income.

It is the policy of Mamora to deduct maximum CCA in each year.

3. The accounting income figure included a Gain On The Sale Of Vacant Land of $75,000. This land had been acquired several years ago for $620,000. While the Company had intended to construct a new building on this site, they had concluded that their current operations did not justify this investment. Given this, the land was sold for $695,000. The buyer provided a 2019 payment of $295,000, with the balance due in four annual payments of $100,000 each, beginning on December 31, 2020.

4. The Company spent $53,000 during the year on landscaping for its new building. While this was treated as an asset for accounting purposes, Mamora did not amortize the balance as it believed the work had an unlimited life.

5. Using the formula found in the *Income Tax Regulations*, 88 percent of Mamora's income has been allocated to provinces.

6. Mamora's accounting income includes foreign business income of $15,300. This amount is net of withholdings in the foreign jurisdiction in the amount of $2,700.

7. As the Company expects to issue more shares during 2020, it made a number of amendments to its articles of incorporation. The legal costs for these changes were $21,000. They have been deducted in the determination of accounting income.

8. Other amounts deducted in the determination of accounting income are as follows:

| | |
|---|---|
| Bond discount amortization | $ 4,600 |
| Donations to registered charities | 12,500 |
| Interest on late income tax instalments | 1,400 |
| Interest on late municipal tax payments | 625 |

9. Accounting income was reduced by $42,000 for the cost of business meals and entertainment. In addition, a deduction of $23,000 was made for the cost of a membership in a golf club for the president of the Company. She uses the club only for entertaining business clients.

10. At the beginning of 2019, Mamora had a net capital loss carry forward of $210,000, as well as a non-capital loss carry forward of $95,000.

11. For 2019, Mamora has active business income in Canada of $976,380, $425,000 of which results from M&P activity.

12. Mamora Ltd. is associated with several other CCPCs. Mamora's share of the group's annual business limit for 2019 is $175,000. The combined Taxable Capital Employed In Canada of the group of associated companies is less than $10 million in both 2018 and 2019.

13. The combined Adjusted Aggregate Investment Income of the group of associated companies is equal to $39,800 for 2018.

**Required:**

A. Calculate the minimum Net Income For Tax Purposes for Mamora Ltd. for 2019. In addition, calculate the UCC balance on January 1, 2020 for each class of assets. Ignore the possibility of using the replacement property election.

B. Calculate the minimum Taxable Income for Mamora Ltd. for 2019. Indicate the amount, and type, of any carry overs that are available at the end of the year.

C. Calculate the minimum federal Part I Tax Payable for Mamora Ltd. for 2019. As the corporation operates in provinces that have a reduced tax rate for M&P activity, a separate calculation of the federal M&P deduction is required. Assume that the foreign tax credit for foreign business income is equal to the foreign taxes withheld.

# CHAPTER 13

# Taxation Of Corporate Investment Income

## Note On Current Developments

As was discussed more extensively in a note at the beginning of Chapter 12, the government is concerned about the accumulation of passive investments resulting from the retention of the after tax income that has been taxed at low corporate rates. As a reflection of this concern, legislation related to the income on such passive investments becomes effective for years that begin after 2018.

In simple terms, when such passive income exceeds $50,000 per year, there will generally be a reduction (grind) in the annual business limit that is available to Canadian Controlled Private Corporations (CCPCs). This annual business limit grind was covered in Chapter 12, along with the grind that occurs when a CCPC has Taxable Capital Employed in Canada (TCEC) in excess of $10 million.

As noted in that Chapter, there is a second component of the legislation related to passive investments. You will recall from Chapter 7 that dividends that are designated as eligible are taxed more favourably than non-eligible dividends. The new legislation does not change the ability to designate dividends as eligible. What has changed is the corporation's ability to access refundable taxes on the payment of eligible dividends. Corporations will be faced, in some situations, with the choice of giving up potential refunds if dividends are designated as eligible, and not designating eligible dividends in order to recover these taxes. This is likely to make the accumulation of investment income in private corporations less attractive.

We would note that this legislation will make the material in this Chapter much more complex, both in the text and in the majority of the problem material.

## Integration

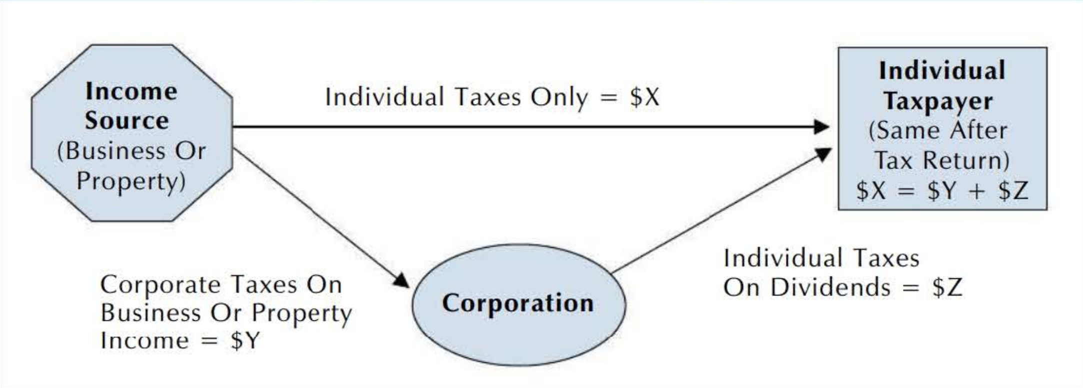
### The Basic Concept

#### *The Goal*

13-1. An individual who is entitled to receive business or property income has the choice of:

- Receiving that income directly as an individual. If this approach is used, the only taxes that will be assessed are at the personal level.

**Figure 13 - 1 The Goal Of Integration**




- Alternatively, the relevant assets can be transferred to a corporation. If this approach is used, there will be two levels of taxation. The income will be subject to corporate taxes prior to its distribution. Then, when the after tax amounts are distributed, they will be subject to a second level of tax at the personal level.

13-2. As depicted in Figure 13-1, the goal of integration is to ensure that the use of a corporation does not alter the total amount of taxes that will be paid on a given stream of business or property income. Stated alternatively, integration procedures are directed at equating the amount of taxes paid by an individual on the direct receipt of income, with the combined corporate/individual taxes that would be paid if that same stream of income was channeled through a corporation.

## Integration Procedures

13-3. As we will find in the various chapters dealing with corporate taxation, there are a number of procedures associated with achieving this goal. However, from the point of view of individual taxpayers, the dividend gross up and tax credit procedures are the primary tools used in building a system which integrates corporate and individual tax amounts.

13-4. As discussed in Chapter 7, the basic idea underlying the gross up and tax credit procedures is that the taxable amount of dividends received by an individual will be grossed up to reflect the amount of pre-tax income earned by the corporation. This will be accompanied by a credit against Tax Payable that will compensate the individual for the taxes that were paid at the corporate level. A simple example, using hypothetical rates, will serve to illustrate the fundamentals of this approach:

**EXAMPLE** Marion Fluery has a business that produces $100,000 of income in each year. If she receives this income directly from the business, it will be subject to tax at her marginal rate of 51 percent.

Alternatively, if she transfers this business to a corporation, the corporation will be subject to taxes at 20 percent.

When the after tax income of the corporation is distributed as dividends, it will be subject to a gross up of 25 percent. The combined federal/provincial dividend tax credit in Marion's province is equal to the amount of the gross up.

**ANALYSIS** If the business does not incorporate, Marion's after tax retention would be as follows:

| | |
|---|---|
| Pre Tax Income | $100,000 |
| Personal Taxes At 51 Percent | ( 51,000) |
| After Tax Retention | $ 49,000 |

If, alternatively, the business is transferred to a corporation, results at the corporate level would be as follows:

| | |
|---|---|
| Corporate Income Before Taxes | $100,000 |
| Corporate Taxes At 20 Percent | ( 20,000) |
| After Tax Income And Maximum Dividend Payable | $ 80,000 |

If the maximum dividend is paid by the corporation and a gross up of 25 percent is applied to this amount, the result would be as follows:

| | |
|---|---|
| Dividends Received | $ 80,000 |
| Gross Up [(25%)($80,000)] | 20,000 |
| Taxable Dividends = Pre-Tax Corporate Income | $100,000 |

As the amount of the gross up is equal to the corporate taxes paid, adding the gross up results in taxable dividends equal to the pre-tax corporate income.

Based on this amount, Marion's Tax Payable would be calculated as follows:

| | |
|---|---|
| Taxable Dividends (After Gross Up) | $100,000 |
| Marion's Tax Rate | 51% |
| Tax Payable Before Dividend Tax Credit | $ 51,000 |
| Dividend Tax Credit (Equal To Gross Up) | ( 20,000) |
| Marion's Tax Payable | $ 31,000 |

Based on the preceding calculation of Tax Payable, Marion's after tax retention would be calculated as follows:

| | |
|---|---|
| Dividends Received | $80,000 |
| Tax Payable | ( 31,000) |
| After Tax Retention - Use Of Corporation | $49,000 |

13-5. You will note that this is exactly the same $49,000 of after tax retention that would result from Marion receiving the $100,000 in income directly and being taxed on it at 51 percent. This means that, in this example, the gross up and tax credit procedures have produced perfect integration. That is, Marion has retained exactly the same amount of after tax income, without regard to whether the pre-tax income is received directly or, alternatively, is channeled through a corporation.

**AN IMPORTANT NOTE An understanding of dividend gross up and tax credit procedures is essential to the material which follows in this Chapter and Chapters 14, 15 and 16. If you do not fully understand these procedures, you should review the material on dividends that is found in Chapter 7.**

## Eligible Vs. Non-Eligible Dividends

### *The Problem*

13-6. The preceding example illustrates the fact that, given the appropriate combination of corporate tax rate, gross up percentage, and dividend tax credit rate, the dividend gross up and tax credit procedures can provide perfect integration. In attempting to implement a system that provides for integration, all of the provinces use the federal gross up rates. However, there are significant variations in effective corporate tax rates, both because of the type of income earned by the corporation and the different rates applied at the provincial level. This means that there is no possibility that any single combination of gross up and tax credit rates could consistently provide integration for all corporations.

13-7. For many years, the government ignored this issue, applying a single gross up rate and a single dividend tax credit rate, without regard to the differences in corporate tax rates. While it would not have been practical to have an array of gross up and credit rates that would reflect all of the different corporate tax rates, it was recognized that the single rate approach was not proving effective in providing for integration. In particular, the single rate that was being used was unfair to public companies that were subject to much higher rates than those applicable to CCPCs earning active business income (see Chapter 12).

13-8. In response to this problem, a dual system of rates was developed. The two rate system was based on a split between dividends paid out of income that was taxed at full corporate rates and dividends paid out of income that benefitted from the small business deduction or refundable taxes. The former were referred to as eligible dividends, with the latter being referred to as non-eligible. In general terms, most of the dividends paid by public companies will be designated as eligible. In contrast, most of the dividends paid by CCPCs will not be designated as eligible and, as a result, will be non-eligible.

## Eligible Dividends

13-9. You may recall from Chapter 7 that ITA 89(1) defines eligible dividends as any taxable dividend that is designated as such by the company paying the dividend (designation procedures are covered in detail later in this Chapter). Dividends that are designated as eligible are grossed up by 38 percent and receive a federal dividend tax credit equal to 6/11 of the 38 percent gross up. As was discussed in Chapter 7, the application of these rates will result in the shareholder receiving these dividends being taxed at a more favourable tax rate than would be the case if the dividends were non-eligible. The term eligible dividends refers to the fact that such dividends are eligible for this "enhanced" dividend tax credit procedure.

13-10. With the exception of capital dividends, all types of dividends may be designated as eligible dividends. This includes the cash dividends, stock dividends, dividends in kind, and the various types of deemed dividends that will be introduced in Chapter 14 (e.g., ITA 84(3) dividends on redemption of shares).

## Non-Eligible Dividends

13-11. It is common terminology to refer to dividends that have not been designated as eligible, as non-eligible dividends, and this is the term we use. (Unfortunately, the term used in tax returns is "other than eligible" dividends which can cause confusion.) For 2019, these non-eligible dividends are grossed up by 15 percent and receive a federal dividend tax credit of 9/13 of the 15 percent gross up.

13-12. Any taxable dividend that has not been designated as eligible will be considered to be non-eligible. This includes cash dividends, stock dividends, dividends in kind, and the various types of deemed dividends that are discussed in Chapter 14. Note, however, as capital dividends are not taxable dividends, they do not qualify for either the dividend gross up procedure or the tax credit procedure.

## Importance

13-13. The distinction between eligible and non-eligible dividends is extremely important. The reasons for this are as follows:

> **Effective Tax Rates** For an individual subject to maximum tax rates, the effective tax rates on non-eligible dividends can be over 10 percentage points higher than the rate on eligible dividends. Note, however, the size of this difference varies considerably from province to province, ranging from less than 5 percentage points to over 10 percentage points.
>
> **Tax Free Dividends** As we will discuss in Chapter 15, an individual with no other source of income can receive a substantial amount of dividends without paying any taxes. For a single individual receiving non-eligible dividends, the amount is just over \$30,000. In contrast, this same individual could avoid taxes on nearly \$60,000 of

eligible dividends. This is of great importance when a source of income is being split with low income family members. Keep in mind, however, that this process is made much more difficult with the expansion of the Tax On Split Income (TOSI).

13-14. Because of this importance, we will need to give attention to the rules for designating dividends as eligible. These rules will be covered after our discussion of Part I and Part IV refundable taxes. However, with the need to divide the Refundable Dividend Tax On Hand (RDTOH) account into eligible and non-eligible components, the material on designating eligible dividends will be covered prior to dealing with these accounts.

## Rates Required For Integration

### *Corporate Rates And Provincial Dividend Tax Credits*

13-15. The goal of integration is to ensure that, if an individual chooses to channel an income stream through a corporation, he will retain the same after tax amount of funds that he would have retained if he had received the income directly. The procedures associated with integration are directed at equating the amount of taxes paid by an individual who does not incorporate an income source and pays taxes only at the individual level, with the total amount of taxes that would be paid if the relevant assets were transferred to a corporation and the resulting income taxed at both the corporate level and at the individual level on distribution of the after tax corporate income.

13-16. In Chapter 7, we also demonstrated that, for integration to work, certain assumptions were required with respect to both the combined federal/provincial tax rate on corporations and the combined federal/provincial dividend tax credit. As noted in that chapter, those assumptions are as follows:

**Corporate Federal/Provincial Tax Rate** For integration to work perfectly, the corporate rate must be such that the dividend gross up percent must restore the after tax corporate amount to the pre corporate tax amount. The relevant rates are as follows:

- For eligible dividends which have a 38 percent gross up, the required rate is 27.54 percent. For example, $10,000 of corporate income would result in corporate taxes of $2,754 and an after tax amount of $7,246 ($10,000 - $2,754). When the $7,246 is grossed up by 38 percent, the result is the original $10,000 [($7,246)(1.38)] of corporate earnings.
- For non-eligible dividends which have a 15 percent gross up, the required rate is 13.04 percent. For example, $10,000 of corporate income would result in corporate taxes of $1,304 and an after tax amount of $8,696 ($10,000 - $1,304). When the $8,696 is grossed up by 15 percent, the result is the original $10,000 [($8,696)(1.15)] of corporate earnings.

If the provincial dividend tax credit is at the level required for integration, combined corporate tax rates above 27.54 percent (for eligible dividends) and 13.04 percent (for non-eligible dividends) will result in higher taxation on income flowed through a corporation. This type of situation is referred to as under integration.

**Provincial Dividend Tax Credit** For the total taxes on income flowed through a corporation to be equal to taxes that would be paid on the direct receipt of income, there must be a credit against personal taxes that is equal to the taxes paid at the corporate level. As you can see in our examples of the required rates for perfect integration, when the corporate tax rate is the one required for perfect integration, the gross up will be equal to the corporate taxes paid. Putting these two facts together leads to the conclusion that the combined dividend tax credit must be equal to the gross up of dividends received. The required rates are as follows:

- For eligible dividends, the federal dividend tax credit is equal to 6/11 of the gross up (54.5%). This means that, for the combined credit to equal the gross up, the provincial credit must be equal to 5/11 (45.5%) of the gross up.

**Figure 13 - 2**
**Corporate Rates And Dividend Tax Credits Required For Integration**

| Type Of Dividends | Required Corporate Combined Tax Rate | Required Provincial Dividend Tax Credit |
|---|---|---|
| Eligible (38% Gross Up) | 27.54% | 5/11 ≈ 45.5% |
| Non-Eligible (15% Gross Up) | 13.04% | 4/13 ≈ 30.8% |

- For non-eligible dividends, the federal dividend tax credit is equal to 9/13 of the gross up (69.2%). This means that, for the combined credit to equal the gross up, the provincial credit must be equal to 4/13 (30.8%) of the gross up.

If the corporate tax rate is at the level required for integration, provincial dividend tax credits below these rates will result in under integration, (i.e., additional taxation because a corporation is used). These required tax and dividend credit rates are summarized in Figure 13-2.

## *Actual Vs. Required Corporate Tax Rates*

13-17. It is important to be aware of how closely actual corporate tax rates compare to the rates required to implement integration. The following general comments are relevant to this:

**Eligible Dividends** For eligible dividends, integration requires a combined federal/provincial corporate tax rate of 27.54 percent. As most eligible dividends will be paid by public companies, the relevant rate is the one applicable to these companies. The combined rates for such companies currently range from roughly 26 to 31 percent. As these rates are fairly close to the required 27.54 percent, integration is working reasonably well, with modest amounts of over or under integration in specific provinces.

**Non-Eligible Dividends** For non-eligible dividends, integration requires a federal/provincial tax rate on corporations of 13.04 percent. The situation here is more complex in that the source of such dividends may be either the income of CCPCs that have benefitted from the small business deduction, or the investment income of such companies.

To the extent that the non-eligible dividends reflect income that has benefitted from the small business deduction, the appropriate combined federal/provincial rates range from 9 percent to about 14 percent (this ignores Quebec's unusually high rate on this income). As was the case with eligible dividends, these rates are close to the required 13.04 percent, suggesting that integration is working fairly well here.

There is a problem, however, when the source of the non-eligible dividends is investment income earned by CCPCs. As we shall discover in this Chapter, the combined federal/provincial rates on this type of income are, in general, over 50 percent. While integration would clearly not work with overall corporate rates at this level, we will find that the effect of these rates is mitigated by the fact that a substantial portion of these taxes are refunded to the corporation when the investment income is paid out to shareholders as dividends.

13-18. For both types of dividends, the preceding analysis makes it clear that the effectiveness of integration is very dependent on the province in which the corporation operates.

## *Actual Vs. Required Dividend Tax Credits*

13-19. Also of importance is the relationship between actual provincial dividend tax credit rates and those that currently exist. The following general comments are relevant here:

**Eligible Dividends** For eligible dividends, the required provincial dividend tax credit is 45.5 percent of the gross up. There is currently a wide range of such credits, going from under 20 percent to just over 45 percent. However, the distribution is skewed to the low side, with the average rate being approximately 30 percent. Given this, there will generally be under integration with respect to eligible dividends.

**Non-Eligible Dividends** For non-eligible dividends, the required provincial dividend tax credit rate is 30.8 percent of the gross up. Here again, there is a wide range of actual rates. However, the average is just under 30 percent, which suggests that integration is working better for this type of dividend.

13-20. As is the case with corporate tax rates, variations in the dividend tax credit rates make it clear that the effectiveness of integration is highly dependent on the province in which the shareholder resides.

## Exercise Thirteen - 1

**Subject:** Integration (Non-Eligible Dividends)

Jan Teason has a business that she estimates will produce income of $100,000 during the taxation year ending December 31, 2019. If she incorporates this business, all of the income would be eligible for the small business deduction and any dividends paid will be non-eligible. In the province where she lives, such corporate income is taxed at a combined federal/provincial rate of 15 percent. Ms. Teason has other income sources that place her in a combined federal/provincial tax bracket of 45 percent. In her province, the provincial dividend tax credit on non-eligible dividends is equal to 30 percent of the gross up. Would Ms. Teason save taxes if she was to channel this source of income through a corporation? Explain your result.

## Exercise Thirteen - 2

**Subject:** Integration (Eligible Dividends)

John Horst has a business that he estimates will produce income of $100,000 during the taxation year ending December 31, 2019. Because he controls another corporation that fully utilizes $500,000 of its small business deduction, if he incorporates this business, none of this income will be eligible for the small business deduction and any dividends paid would be designated eligible. In the province where he lives, such corporate income is taxed at a combined federal/provincial rate of 30 percent. Mr. Horst has other income sources that place him in a combined federal/provincial tax bracket of 42 percent. In his province, the provincial dividend tax credit on eligible dividends is equal to 28 percent of the gross up. Would Mr. Horst save taxes if he was to channel this source of income through a corporation? Explain your result.

**SOLUTIONS available in print and online Study Guide.**

**We suggest you work Self Study Problem Thirteen-1 at this point.**

### *Alternative Calculations For Dividend Tax Credits*

13-21. Note that, while federal legislation calculates the dividend tax credit as a fraction of the gross up, you often see this credit expressed as a percentage of dividends received, or a percentage of the grossed up amount of the dividends.

13-22. Because our focus is largely on federal legislation, we will generally present dividend tax credits as a fraction of the gross up. However, if needed, it is quite simple to convert different approaches to a uniform base. For example, if an eligible dividend of $100 is paid, the federal dividend tax credit of $20.73 can be calculated as:

- 6/11 (54.55%) of the $38 [(38%)($100)] gross up. (Which is our standard approach.)
- 20.73 percent of the $100 in dividends received, or
- 15.02 percent of the $138 of grossed up dividends.

# Refundable Taxes On Investment Income

## Meaning Of Aggregate Investment Income

### Regular Meaning

13-23. In the following material on refundable taxes, we will be using the term Aggregate Investment Income. For purposes of determining the amount of refundable taxes available, this term is defined in ITA 129(4) and has a very specific definition. You may recall that we provided this definition in Chapter 12 and it is also included at the front of this text in "Rates And Other Data". It is provided again here for your convenience.

**ITA 129(4) Aggregate Investment Income**

| | |
|---|---|
| Net Taxable Capital Gains | $xxx |
| Interest | xxx |
| Rents | xxx |
| Royalties | xxx |
| Total Positive Amounts | $xxx |
| Net Capital Loss Carry Overs Deducted During The Year | ( xxx) |
| ITA 129(4) Aggregate Investment Income | $xxx |

13-24. Note carefully the differences between this Aggregate Investment Income and what we normally think of as property or investment income. Unlike the normal definition of property or investment income, this concept includes net taxable capital gains for the current year, reduced by net capital loss carry overs deducted during the year.

13-25. The other difference between Aggregate Investment Income and the usual definition of investment income is that it excludes most dividends from other Canadian corporations. This reflects the fact that dividends from Canadian corporations generally flow through a corporation without being subject to Part I corporate taxes. You should also note that Aggregate Investment Income includes income from both Canadian and foreign sources.

### ADJUSTED Aggregate Investment Income

13-26. Chapter 12 introduced an alternative definition of investment income, referred to as ADJUSTED Aggregate Investment Income [ITA 125(7)]. We have capitalized ADJUSTED to avoid confusion with Aggregate Investment Income and because this is the first year the term has been in use. This ADJUSTED definition differs from the regular definition as follows:

- It includes dividends from taxable Canadian corporations with the exception of those from connected corporations. This can also be referred to as portfolio dividends.
- It only includes net taxable capital gains on the disposition of assets that are not used in an active business.
- There is no deduction for net capital loss carry overs that are deducted during the current year.

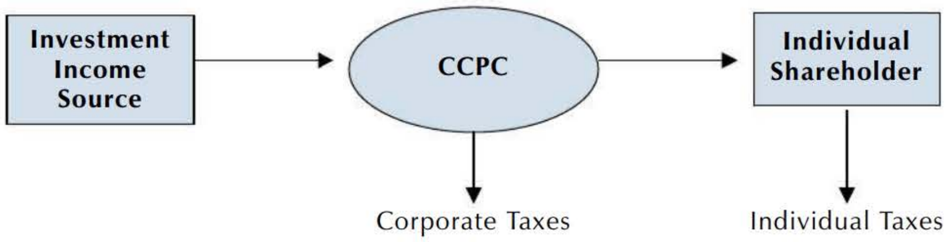
13-27. It is important to note that this alternative ADJUSTED definition is only used for the determination of the annual business limit grind. In all other applications, the ITA 129(4) definition of Aggregate Investment Income is used.

## Basic Concepts

### The Problem

13-28. As shown in Figure 13-3 (following page), when income is flowed through a corporation, it is subject to two levels of taxation. It is taxed first at the corporate level and, if the after tax corporate amount is distributed to the individual shareholder, it will be taxed again in the

**Figure 13 - 3**
**Tax On Flow Through Of Investment Income**




hands of that individual. If we assume that the corporate tax rate on the investment income of a CCPC is 52 percent and that the individual shareholder is taxed at a combined rate of 39 percent on non-eligible dividends received, the overall rate of taxation on investment income flowed through a corporation would be 70.7 percent [52% + (1 - 52%)(39%)].

13-29. This is significantly higher than the maximum federal/provincial tax rate on Canadian individuals of 54 percent. Such a large difference is clearly not consistent with the concept of integration. Given this, it was necessary to find some method of providing tax relief for shareholders of CCPCs earning investment income.

### The Solution

13-30. The most obvious solution to this problem would be to lower the rate of corporate taxation on the investment income of a CCPC. For example, if the corporate rate was lowered to 22 percent, the overall rate on the flow through of income would be taxed at 52.4 percent [22% + (1 - 22%)(39%)]. This is within the range of rates that are applied to high net worth individuals who receive business or property income directly.

13-31. The problem with this solution is that it would provide for a significant deferral of taxes on investment income. If an individual received the investment income directly, the full amount of taxes must be paid when the income is earned. In contrast, when a corporation is used, only the first, or corporate level, of taxation is assessed when the income is earned. If the after tax amount is left in the corporation, the assessment of the individual level of tax can be deferred indefinitely.

13-32. For higher income individuals who do not require all of their investment income for current expenditures, this would present an outstanding opportunity for tax deferral, as well as for the accumulation of large portfolios of passive investments. This would be the case whenever the corporate tax rate on investment income is below the rate applicable to the individual on the direct receipt of income.

13-33. Given the opportunity for tax deferral that would result from the use of lower corporate tax rates, it is not surprising that a different solution to the problem of excessive tax rates on the flow through of a CCPC's investment income has been adopted. This solution involves leaving the corporate tax rate at a high level, but having a portion of the tax being designated as refundable. The refund of this portion of the corporate tax occurs when the income is distributed in the form of dividends that will be subject to the second level of taxation in the hands of the shareholders.

13-34. Consistent with this concept of keeping the basic rate high on the Aggregate Investment Income of a CCPC, this type of income is excluded from the definition of Full Rate Taxable Income and, as a consequence, is not eligible for the general rate reduction.

### Refundable Tax Procedures

13-35. While the detailed procedures related to these refundable taxes are complex, the basic concept is not. A portion of the tax paid on investment income at the corporate level is

refunded when the income is distributed to investors in the form of dividends. This keeps the combined corporate and personal tax rate in line with the rate that would be applicable to an individual on the direct receipt of income. The high rate of corporate tax discourages tax deferral, while at the same time, the refund procedures avoid the excessive rate of taxation that would occur if this high corporate tax rate was combined with individual taxes on the same income stream.

13-36. Stated simply, the use of a refundable tax allows the government to charge a corporate tax rate that is high enough to remove much of the incentive for accumulating investment income in a corporation and, at the same time, provides a reasonable overall rate of taxation when the income is flowed through the corporation and taxed in the hands of the individual shareholder.

13-37. In implementing this refundable tax approach, the *Income Tax Act* designates three different components of total taxes paid that can be refunded on the payment of dividends. They can be described as follows:

**Ordinary Part I Tax** At this point, you should be familiar with the calculation of the regular Part I tax that is assessed on the Taxable Income of a corporation. A portion of this tax, conceptually the portion of the Part I tax that is applicable to investment income, will be designated as refundable on the payment of dividends. Note the fact that a portion of the Part I tax being designated as refundable does not change, in any way, the manner in which the Part I tax is calculated.

**Additional Refundable Tax On Investment Income (ART)** The Additional Refundable Tax On Investment Income, a Part I tax, was introduced in order to ensure that the combined federal/provincial tax on investment income was sufficiently high that it would discourage the use of a corporation to defer taxes. To achieve this objective, this combined tax rate had to be at a level that was higher than the rate applicable to high net worth individuals.

The ART rate is 10-2/3 percent, resulting in a federal rate on investment income of 38-2/3 percent (38% - 10% + 10-2/3%). When the various provincial rates on this type of income are taken into consideration, applicable combined rates are all in excess of 50 percent, with the top rate at nearly 55 percent. As this is comparable to, or higher than, the maximum rate on individuals in all of the provinces, ART serves to discourage earning investment income that is retained within a corporation.

**Part IV Tax** Even with the Part I refundable tax and ART in place, there is still the possibility of using a related group of corporations to defer taxation on investment income. Based on this, a Part IV tax is assessed at a rate of 38-1/3 percent on certain intercorporate dividends received by a private corporation.

13-38. In dealing with this material, we will first consider the issues involved with a single corporation. In these single corporation situations, only the refundable Part I tax and the additional refundable tax on investment income will be considered.

# Refundable Part I Tax On Investment Income

## Additional Refundable Tax On Investment Income (ART)

### *Basic Calculations*

13-39. As was noted previously, tax legislation contains a refundable tax on the investment income of a Canadian controlled private corporation (CCPC). This additional refundable tax (ART) is assessed under ITA 123.3 (the definition is available at the front of this text in "Rates And Other Data"). The amount payable is equal to 10-2/3 percent of the lesser of:

- the corporation's "Aggregate Investment Income" for the year [as defined in ITA 129(4)]; and
- the amount, if any, by which the corporation's Taxable Income for the year exceeds the amount that is eligible for the small business deduction.

13-40. The basic objective of this tax is to make it undesirable to shelter investment income within a corporate structure in order to defer full taxation of the amounts earned. As we have noted, when this additional 10-2/3 percent is added to the usual rates applicable to a CCPC's investment income, the combined rate is over 50 percent in all provinces.

13-41. This means that, with the addition of the ART, rates on the investment income of a CCPC will generally be higher than the rates applicable to an individual receiving the same income directly. Given this, there is little or no tax incentive to use a corporation to defer taxation on this type of income.

13-42. As described in Paragraph 13-39, the ART is based on the lesser of Aggregate Investment Income and the amount of Taxable Income that is not eligible for the small business deduction. The reason for the latter limit is to ensure that such deductions as charitable donations or non-capital loss carry overs have not totally or partially eliminated the investment income from the amount flowing through to Taxable Income. The goal is to prevent the ART from being inappropriately applied to active business income.

## Exercise Thirteen - 3

**Subject:** Additional Refundable Tax On Investment Income

Zircon Inc. is a CCPC with a December 31 year end. Zircon is not associated with any other company. For the 2019 taxation year, its Net Income For Tax Purposes is equal to $281,000. This is made up of active business income of $198,000, dividends from taxable Canadian corporations of $22,000, interest income on long-term investments of $15,000 and taxable capital gains on the disposition of capital assets used in the active business of $46,000.

The Company has available a net capital loss carry forward of $26,000 [(1/2)($52,000)] and a non-capital loss carry forward of $23,000. The Company intends to deduct both of these carry forwards in the 2019 taxation year. In 2018, the corporation's ADJUSTED Aggregate Investment Income was $13,000, and its Taxable Capital Employed In Canada was $6 million.

Determine Zircon's Taxable Income and its additional refundable tax on investment income for the 2019 taxation year.

**SOLUTION available in print and online Study Guide.**

### ART And Foreign Tax Credit Calculations

13-43. As discussed in Chapter 12, the use of foreign taxes paid as credits against Canadian Tax Payable is limited by a formula that includes the "tax otherwise payable". In the case of foreign taxes paid on non-business income, the "tax otherwise payable" in the formula adds the ART that is assessed under ITA 123.3.

13-44. This creates a potential problem in that the calculation of the ART includes the amount eligible for the small business deduction. Since one of the factors limiting the small business deduction [ITA 125(1)(b)] is Taxable Income reduced by 100/28 of the foreign non-business income tax credit and 4 times the foreign business income tax credit, this could have created an insolvable circular calculation.

13-45. As is explained in Chapter 12, there is a similar circularity issue involving the general rate reduction under ITA 123.4. The calculation of this amount also requires knowing the amount of income that is eligible for the small business deduction.

13-46. To avoid both of these problems, for the purposes of calculating the small business deduction, ITA 125(1)(b)(i) permits the foreign tax credit for taxes paid on foreign non-business income to be calculated using a "tax otherwise payable" figure that does not include the ART under ITA 123.3 or the general rate reduction. ITA 125(1)(b)(ii) permits the foreign tax

credit for taxes paid on foreign business income to be calculated using a "tax otherwise payable" figure that does not include the general rate reduction.

13-47. This means that in situations where the small business deduction, foreign tax credits, and the ART are involved, the following procedures should be used:

1. Calculate the foreign non-business tax credit using a "tax otherwise payable" figure that excludes both ITA 123.3 (ART) and ITA 123.4 (general rate reduction). This initial version of the foreign non-business tax credit will be used only for the purpose of determining the small business deduction, with the actual credit available calculated after the ITA 123.3 and 123.4 amounts have been determined.

2. Calculate the foreign business tax credit using a "tax otherwise payable" figure that excludes ITA 123.4 (as business income is involved, ITA 123.3 is excluded by definition). However, this credit is limited by the amount of tax otherwise payable, reduced by the foreign non-business tax credit. As a consequence, it will be necessary to calculate an initial version of this foreign business tax credit, using the initial version of the foreign non-business tax credit. This initial version will be used only for the purpose of determining the small business deduction and the M&P deduction.

3. Calculate the amount eligible for the small business deduction and M&P deduction using the numbers determined in steps 1 and 2.

4. Using the amount eligible for the small business deduction and the M&P deduction determined in step 3, calculate the ART and the general rate reduction.

5. Calculate the actual foreign non-business tax credit using a "tax otherwise payable" figure that includes the ART and the general rate reduction determined in step 4.

6. Calculate the actual foreign business tax credit using the actual foreign non-business tax credit determined in step 5 and the general rate reduction from step 4.

## Problem One: Excessive Tax Rates On The Flow Through Of A CCPC's Investment Income

13-48. With the addition of the 10-2/3 percent ART on the investment income of a Canadian controlled private corporation, this investment income is taxed at a combined federal/provincial rate that is consistently over 50 percent (see Paragraph 13-40).

13-49. All of these combined rates are far higher than the 13.04 percent rate required for perfect integration (the 13.04 percent rate for non-eligible dividends is used as the investment income of a CCPC cannot be used as a basis for paying eligible dividends). In the absence of some type of relieving mechanism, the objective of integrating corporate and individual tax rates would not be met.

13-50. The problem of excessive rates of tax on investment income flowed through a corporation was discussed previously in Paragraph 13-28. This is a more complete example:

**EXAMPLE** Mr. Monroe has investments that generate interest income of $100,000 per year. He is personally subject to a combined federal/provincial tax rate of 49 percent. The dividend tax credit for non-eligible dividends in his province of residence is equal to 4/13 of the gross up. Calculate the amount of cash Mr. Monroe will retain from this investment income under the following alternative assumptions:

**Case A** He receives the $100,000 in interest income directly.

**Case B** Mr. Monroe is the sole shareholder of a Canadian controlled private corporation that earns the $100,000 of investment income. The corporation is subject to a combined federal/provincial tax rate, including the ITA 123.3 tax on investment income, of 54 percent. The corporation pays out all of its after tax earnings as non-eligible dividends, resulting in a dividend to Mr. Monroe of $46,000. Ignore any refund of Part I tax paid.

13-51. The calculations comparing the investment income if it was received directly (Case A) and if it was earned through a corporation (Case B), are as follows:

**Case A - Investment Income Received Directly**

| | |
|---|---|
| Investment Income - Direct Receipt | $100,000 |
| Personal Tax At 49 Percent | ( 49,000) |
| After Tax Cash Retained Without Corporation | $ 51,000 |

**Case B - Investment Income Flowed Through Corporation**
**Assume No Refundable Part I Tax**

| | |
|---|---|
| Corporate Investment Income | $100,000 |
| Corporate Tax At 54 Percent (Includes The ART) | ( 54,000) |
| Non-Eligible Dividends Paid To Mr. Monroe | $ 46,000 |
| Non-Eligible Dividends Received | $ 46,000 |
| Gross Up Of 15 Percent | 6,900 |
| Personal Taxable Income | $ 52,900 |
| Personal Tax Rate | 49% |
| Tax Payable Before Dividend Tax Credit | $ 25,921 |
| Dividend Tax Credit [(9/13 + 4/13)(Gross Up)] | ( 6,900) |
| Personal Tax Payable With Corporation | $ 19,021 |
| Non-Eligible Dividends Received | $ 46,000 |
| Personal Tax Payable | ( 19,021) |
| After Tax Cash Retained With Corporation | $ 26,979 |

**Savings - Direct Receipt**

| | |
|---|---|
| Income Received Directly | $ 51,000 |
| Income Flowed Through Corporation | ( 26,979) |
| Net Savings On Direct Receipt | $ 24,021 |

13-52. The results show that, in the absence of the refundable component of Part I tax, interest income flowed through a corporation is subject to an effective tax rate of over 73 percent [($100,000 - $26,979) ÷ $100,000]. This is significantly higher than the 49 percent rate that is applicable to the direct receipt of the investment income, an outcome that would represent a major failure in the government's attempt to achieve integration.

13-53. Before leaving this example you should note that, with the inclusion of the ART on investment income, there is no deferral advantage associated with using a corporation in this example. The corporate taxes alone are $54,000, well in excess of the $49,000 that would be paid if Mr. Monroe had received the income directly.

## Solution To Problem One: Refundable Portion Of Part I Tax

### *Basic Concepts*

13-54. The preceding example makes it clear that taxes on investment income earned by a CCPC and flowed through to its shareholders are potentially much higher than would be the case if the shareholders received the income directly. This major imperfection in the system of integration results from a federal/provincial tax rate on the investment income of CCPCs that is over 50 percent.

13-55. In those cases where the income is retained in the corporation, this is an equitable arrangement in that this high rate discourages the use of a CCPC to temporarily shelter passive income from a portion of the taxes that would be assessed on the direct receipt of the income

by the individual. However, when the investment income is flowed through a CCPC and paid as dividends, the result is not consistent with the government's desire to tax CCPCs under the integration view of corporate taxation.

13-56. As noted previously, the government could have dealt with this problem by reducing the corporate tax rate on the investment income of CCPCs. However, this would have allowed the owners of CCPCs to defer personal taxes on this income by leaving the investment income in the corporation. To avoid this, the refundable tax approach is used.

13-57. Under this approach, the investment income of Canadian controlled private corporations is taxed at the usual high rates, including the ART on investment income. However, when the corporation distributes its after tax income in the form of dividends, a part of this tax is refunded. Under ITA 129(1), the refund is based on the amount of dividends paid by the corporation, with the refund being equal to 38-1/3 percent of dividends paid.

## Concepts Illustrated

13-58. For integration to work perfectly on non-eligible dividend payments, the overall corporate tax rate has to equal 13.04 percent (see Paragraph 13-16). In order to give you a better understanding of how the concepts associated with the refund of Part I tax work, we will use an example based on a pre-dividend refund tax rate that will provide a 13.04 percent tax rate after the refund has contributed to the total dividend. While we will not go through the calculation of this rate, the required rate is 46.375 percent, including the 10-2/3 percent ART. You should note that this rate is lower than any of the relevant combined federal/provincial rates that are currently available.

13-59. With the initial corporate tax rate at 46.375 percent, a refund is necessary to reduce the rate to the required 13.04 percent. The rate that is specified in ITA 129(1) is 38-1/3 percent of the total dividends paid. As we will discuss later, this refund is limited by the corporation's balance in its Refundable Dividend Tax On Hand account.

13-60. The following example, involving perfect integration, will illustrate the rates that we have just presented.

> **EXAMPLE** Ms. Banardi has investments that generate interest income of $100,000 per year. You have been asked to advise her as to whether there would be any benefits associated with transferring these investments to her wholly owned Canadian controlled private corporation. Ms. Banardi is personally subject to a combined federal/provincial tax rate of 49 percent. The dividend tax credit on non-eligible dividends in her province of residence is equal to 4/13 of the gross up. Her corporation would be taxed on this income at a combined federal/provincial rate of 46.375 percent, including the ART on investment income.
>
> **Note** In the calculations that follow, we have ignored some small rounding issues in order to avoid extending the required rates to more decimal places. This in no way defeats the objective of illustrating the conceptual basis for the Part I refundable tax.

13-61. The calculations comparing the after tax investment income if it was earned in a corporation and if it was received directly, are as follows:

**After Tax Retention - Use Of A Corporation**

| | |
|---|---|
| Corporate Investment Income | $100,000 |
| Corporate Tax At 46.375 Percent (Includes The ART) | ( 46,375) |
| After Tax Income | $ 53,625 |
| Dividend Refund (See Analysis) | 33,335 |
| Non-Eligible Dividends Paid To Ms. Banardi | $ 86,960 |

**ANALYSIS** In this somewhat academic example of the dividend refund mechanism, we assume that all of the corporation's after tax income will be paid out as dividends. Given this, a bit of algebra is needed to determine the total dividend, and in the process, the amount of the refund. Specifically, we need to solve the following simple equation:

X = $53,625 + [(38-1/3%)(X)]
X - [(38-1/3%)(X)] = $53,625
[(61-2/3%)(X)] = $53,625
X = $86,960

Where X = The total dividend, including the refund.

This provides a dividend refund of $33,335 ($86,960 - $53,625), an amount that is equal to 38-1/3 percent of $86,960.

In this example, we have provided a complete illustration of the conversion of available after tax income to a dividend that includes a refund equal to 38-1/3 percent of the total dividend. In future examples, we will use a condensed version of this process to do a direct calculation of the amount of the refund. The formula for the refund is as follows:

Refund = [(After Tax Funds Available ÷ .61667) - After Tax Funds Available]

Applying this to the current example gives the same result that was achieved by the more detailed calculation:

$33,335 = [($53,625 ÷ .61667) - $53,625]

Note that, at this point, the total corporate tax paid is equal to $13,040 ($100,000 - $86,960). This reflects the 13.04 percent rate ($13,040 ÷ $100,000) that is required for perfect integration.

The assumption that all after tax income will be paid out as dividends is not consistent with the real world approach in which the amount of the dividend is determined by a variety of factors (e.g., availability of cash or alternative investment opportunities) and very rarely, if ever, equals the after tax income plus the dividend refund.

Calculation of the after tax amounts retained follows:

| | |
|---|---|
| Non-Eligible Dividends Received | $ 86,960 |
| Gross Up Of 15 Percent | 13,040 |
| Personal Taxable Income | $100,000 |
| Personal Tax Rate | 49% |
| Tax Payable Before Dividend Tax Credit | $ 49,000 |
| Dividend Tax Credit [(9/13 + 4/13)(Gross Up)] | ( 13,040) |
| Personal Tax Payable With Corporation | $ 35,960 |

| | |
|---|---|
| Non-Eligible Dividends Received | $ 86,960 |
| Personal Tax Payable | ( 35,960) |
| After Tax Cash Retained With Corporation | $ 51,000 |

**After Tax Retention - Direct Receipt**

| | |
|---|---|
| Investment Income - Direct Receipt | $100,000 |
| Personal Tax At 49 Percent | ( 49,000) |
| After Tax Cash Retained Without Corporation | $ 51,000 |

13-62. While this example provides equal amounts of after tax cash, without regard to whether the income is flowed through a corporation or received directly, it is not a realistic example. All of the combined federal/provincial rates on the investment income of CCPCs are higher than the 46.375 percent rate used in our example. In addition, as we shall see in the next section of this Chapter, the amount of the refund is limited by the balance in the Refundable Dividend Tax On Hand (RDTOH). We have not taken that into consideration in this example. If we had, the dividend refund in this example would be limited to $30,677 [(30-2/3%)($100,000)].

## Use Of Other Rates In Refundable Part I Tax Example

13-63. In this example, we will use a corporate tax rate of 54-2/3 percent. This will illustrate that, when realistic corporate tax rates are used, using a CCPC to hold assets earning investment income will result in a lower after tax return than holding the investments directly.

> **EXAMPLE** Mr. Leoni has investments that generate interest income of $100,000 per year. He has over $250,000 in other income and is subject to a combined federal/provincial tax rate of 51 percent. The provincial dividend tax credit for non-eligible dividends is equal to 4/13 of the gross up. Mr. Leoni is the sole shareholder of a CCPC and is considering the transfer of these investments to his corporation. His corporation would be taxed on this income at a combined federal/provincial rate of 54-2/3 percent, including the ART on investment income (38% - 10% + 10-2/3% + 16%).

13-64. The calculations comparing the after tax investment income if it was earned through a corporation and if it was received directly, are as follows:

**After Tax Retention - Use Of A Corporation**

| | |
|---|---|
| Corporate Investment Income | $100,000 |
| Corporate Tax At 54-2/3 Percent (Includes The ART) | ( 54,667) |
| After Tax Income | $ 45,333 |
| Dividend Refund [($45,333 ÷ .61667) - $45,333] | 28,180 |
| Non-Eligible Dividends Paid To Mr. Leoni | $ 73,513 |
| | |
| Non-Eligible Dividends Received | $ 73,513 |
| Gross Up Of 15 Percent | 11,027 |
| Personal Taxable Income | $ 84,540 |
| Personal Tax Rate | 51% |
| Tax Payable Before Dividend Tax Credit | $ 43,115 |
| Dividend Tax Credit [(9/13 + 4/13)($11,027)] | ( 11,027) |
| Personal Tax Payable With Corporation | $ 32,088 |
| | |
| Non-Eligible Dividends Received | $ 73,513 |
| Personal Tax Payable | ( 32,088) |
| After Tax Cash Retained With Corporation | $ 41,425 |

**After Tax Retention - Direct Receipt**

| | |
|---|---|
| Investment Income - Direct Receipt | $100,000 |
| Personal Tax At 51 Percent | ( 51,000) |
| After Tax Cash Retained Without Corporation | $ 49,000 |

13-65. There are two things that should be noted here. First, when a 54-2/3 percent corporate tax rate is used, the taxes of $54,667 at the corporate level are significantly higher than the $51,000 that would have been paid if Mr. Leoni had received the income directly. While

there are some combinations of provincial corporate and provincial individual tax rates that would provide for some deferral of taxes at the corporate level, that is clearly not the case with the rates used here.

13-66. With respect to the after tax flow through of investment income, using a corporation is clearly not a good idea. Mr. Leoni has $7,575 ($49,000 - $41,425) less after tax cash, as compared to the amount he would have retained on direct receipt of the $100,000 income. While this difference is particularly large when a 54-2/3 percent corporate tax rate is used, the basic result would be the same when any of the other available corporate tax rates are used. As a result, using a corporation would almost always produce less after tax cash.

### Exercise Thirteen - 4

**Subject:** Flow Through Of Investment Income

Ms. Shelly Nicastro has investments that generate interest income of $100,000 per year. Due to her employment income, she is in the top tax bracket, with a combined federal/provincial rate of 51 percent. She is considering the transfer of these investments to her CCPC which would be subject to a tax rate on investment income of 52 percent (including the ART). The dividend tax credit for non-eligible dividends in her province is equal to 30 percent of the gross up. Any dividends paid by the CCPC out of investment income will be non-eligible. Advise her as to whether there would be any tax benefits associated with this transfer.

**SOLUTION available in print and online Study Guide.**

# Refundable Part IV Tax On Dividends Received

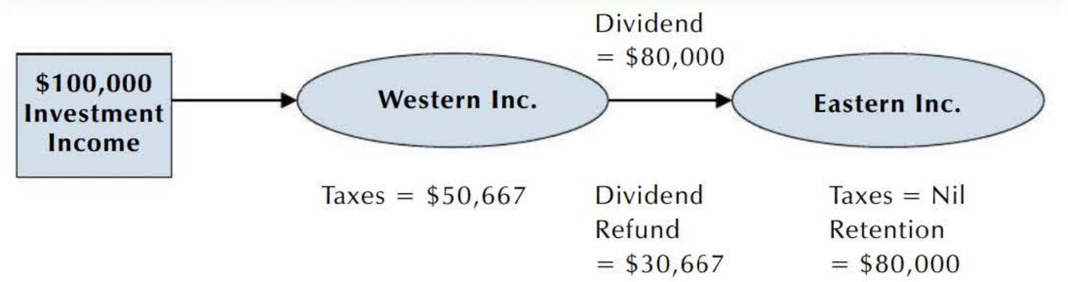
## Problem Two: Use Of Multi-Level Affiliations To Defer Taxes On Investment Income

13-67. In the preceding section, we demonstrated how refund procedures applicable to Part I tax payable are used to lower the overall rate of taxation on the investment income of a CCPC, while at the same time preventing the use of a corporation to defer a portion of the overall taxation on such income. While varying provincial tax rates on corporations and individuals prevent these procedures from providing perfect results, they appear to produce results that come close to achieving the goal of integration of personal and corporate taxes.

13-68. The situation becomes more complex when a group of connected companies is involved. The refundable tax procedures that were previously described are not effective in preventing tax deferral in this case. As a result, there is a need for additional procedures.

**EXAMPLE** Eastern Inc. has a 100 percent owned subsidiary, Western Ltd. Both Companies are Canadian controlled private corporations and have a December 31 year end. During the current year, Western has income of $100,000, made up entirely of interest and taxable capital gains. Assume that the combined federal/provincial tax rate for both Companies is 50-2/3 percent, including the ART. Western pays out all of its after tax income in dividends to Eastern Inc. This situation is illustrated in Figure 13-4 (following page).

**Figure 13 - 4**
**Example Of Taxation On Investment Income In A Connected Group**




**ANALYSIS** On receipt of the $100,000 of investment income, Western would pay taxes of $50,667 [($100,000)(50-2/3%)]. However, when the remaining $49,333 is paid out in dividends, a dividend refund of $30,667 (38-1/3% of the $80,000 total dividend) becomes available, resulting in a total dividend of $80,000 as shown in the following calculation:

| | |
|---|---|
| Investment Income Of Western | $100,000 |
| Corporate Tax At 50-2/3 Percent (Includes The ART) | ( 50,667) |
| Income Before Dividends | $ 49,333 |
| Dividend Refund [($49,333 ÷ .61667) - $49,333] | 30,667 |
| Dividends Paid To Eastern | $ 80,000 |

As the dividends from Western will be received tax free by Eastern, they will have after tax retention of $80,000. Unless Eastern pays out taxable dividends to its individual shareholders, no additional Part I tax will be assessed. This means that, in the absence of additional procedures, there could be a significant deferral of taxes on investment income resulting from the use of two related corporations.

## Solution To Problem Two: Refundable Part IV Tax

### *Corporations Subject To Part IV Tax*

13-69. To eliminate this potential flaw in integration, a Part IV tax is assessed on dividends received by a private corporation from certain other types of corporations. Note that this tax is assessed without regard to whether or not the private corporation is Canadian controlled.

13-70. In general, only private corporations are liable for Part IV tax. However, there remains the possibility that a company that is controlled largely for the benefit of an individual, or a related group of individuals, might use a small issue of shares to the public in order to avoid this tax. Such corporations are referred to as "subject corporations" and they are defined in ITA 186(3) as follows:

> **Subject Corporation** means a corporation (other than a private corporation) resident in Canada and controlled, whether because of a beneficial interest in one or more trusts or otherwise, by or for the benefit of an individual (other than a trust) or a related group of individuals (other than trusts).

13-71. ITA 186(1) indicates that, for purposes of Part IV tax, subject corporations will be treated as private corporations. This means that both private corporations, as well as those public corporations that fall within the definition of subject corporations, will be liable for the payment of Part IV tax. In this Chapter, any subsequent references to private corporations should be considered to include subject corporations.

### Rates

13-72. The Part IV rate is assessed at a rate of 38-1/3 percent. It is applicable to portfolio dividends as well as some dividends from connected corporations (both of these terms will be subsequently explained). The rate at which this tax is refunded is the same as the rate for refunds of Part I tax. Both refunds are at a rate of 38-1/3 percent of the total dividend.

### Applicable Dividends

13-73. The Part IV tax is only applicable to certain types of dividends received by private corporations. Specifically, Part IV tax is payable on dividends received by private corporations in the following circumstances:

- A dividend is received from an unconnected company that is deductible in the calculation of the recipient's Taxable Income. While the *Income Tax Act* refers to such dividends as "assessable dividends", it is a common practice to refer to such dividends as "portfolio dividends", a practice we will follow in the remainder of this text.
- The dividend is received from a connected company that, as a result of making the dividend payment, received a dividend refund.

13-74. Each of these types of dividends will be given attention in the material which follows.

## Part IV Tax On Portfolio Dividends Received

### Portfolio Dividends And Connected Corporations Defined

13-75. A portfolio dividend is defined as a dividend received by a private corporation from a corporation to which it is not connected, and that is deductible in the determination of the private corporation's Taxable Income. As with many *Income Tax Act* terms, the definition of a portfolio dividend includes another term which requires definition. This term is "connected corporation" and the definition is found in ITA 186(4). Under this definition, a connected corporation is either:

- a controlled corporation, where control represents ownership of more than 50 percent of the voting shares by any combination of the other corporation and persons with whom it does not deal at arm's length, or
- a corporation in which the other corporation owns more than 10 percent of the voting shares, and more than 10 percent of the fair market value of all of the issued shares of the corporation.

13-76. Given the definition of connected corporation, a 10 percent shareholding test is generally used to determine whether the dividends received are portfolio dividends or dividends from a connected corporation.

> **EXAMPLE** A dividend is received on an investment made by a private company in 500 shares of a large publicly traded company that has 15 million shares outstanding.
>
> **ANALYSIS** The 500 shares would be significantly less than 10 percent of the total shares outstanding and would not constitute control of the company. As a consequence, the dividends would be considered portfolio dividends and the Part IV tax would be applicable.

### Portfolio Dividends And Integration

13-77. The tax policy issue with respect to portfolio dividends relates to integration. If such dividends are received by an individual, they are normally subject to taxation. For example, assume that an individual receives $100,000 in dividends. This individual is subject to a combined federal/provincial marginal rate of 45 percent and lives in a province with a dividend tax credit equal to 5/11 of the eligible dividend gross up and 4/13 of the non-eligible dividend gross up. The resulting Tax Payable would be calculated as follows:

| | Eligible Dividends | Non-Eligible Dividends |
|---|---|---|
| Dividends Received | $100,000 | $100,000 |
| Gross Up Of 38 or 15 Percent | 38,000 | 15,000 |
| Taxable Income | $138,000 | $115,000 |
| Personal Tax Rate | 45% | 45% |
| Tax Payable Before Dividend Tax Credit | $ 62,100 | $ 51,750 |
| Dividend Tax Credit: | | |
| [(6/11 + 5/11)(Gross Up)] | ( 38,000) | |
| [(9/13 + 4/13)(Gross Up)] | | ( 15,000) |
| Personal Tax Payable | $ 24,100 | $ 36,750 |

13-78. As an alternative, consider what would happen if the same $100,000 in dividends had been received by a corporation. Under the general rules for intercorporate dividends, the $100,000 would be deductible in the calculation of the corporation's Taxable Income, resulting in no Part I tax at the corporate level. While tax will ultimately be paid when the corporation distributes this income to its shareholders, there is a potential for significant deferral of taxes until such time as this corporation distributes the income as dividends.

13-79. In order to correct this flaw in the corporate tax integration system, Part IV tax is applied as follows:

> **Part IV Tax - Portfolio Dividends** When a private corporation receives a dividend on shares that are being held as a portfolio investment, the recipient company is liable for a Part IV tax of 38-1/3 percent of the dividends received. This Part IV tax is refundable, on the basis of 38-1/3 percent of dividends paid, when such dividends are passed on to the shareholders of the recipient corporation.

13-80. We can see the reasoning behind the rate of this tax by referring back to the preceding example in Paragraph 13-76. You will notice that the effective tax rate on the eligible dividends received by the individual is 24.1 percent ($24,100 ÷ $100,000). By charging a Part IV tax of 38-1/3 percent at the corporate level, the tax paid by the corporation is in excess of the 24.1 percent effective tax rate that would apply to eligible dividends received by an individual with a tax rate of 45 percent. This makes it unattractive to use a private corporation as a shelter to defer the payment of taxes on dividend income. Again, however, by making the tax refundable, it allows the dividends to flow through the recipient corporation without assessing an unreasonable level of taxation on the income flowed through a corporation.

## Dividends From A Connected Corporation

### *The Investment Income Problem*

13-81. It is the intent of the government to allow a Canadian controlled private corporation to be used to defer taxes on active business income. Earning such income entitles the corporation to the use of the small business deduction and this, in most situations, provides a rate of corporate taxation that will effectively defer taxes on income left in the corporation. To the extent that a connected corporation is paying dividends out of such income, there will be no dividend refund and no Part IV tax to be paid by the recipient corporation. This maintains the tax deferral on active business income as it moves between corporations.

13-82. However, when the connected corporation is a private company (whether or not it is Canadian controlled) and the dividends are paid out of investment income, a problem arises. This problem was illustrated by the example presented in Paragraph 13-68.

13-83. In that example, Western paid an $80,000 dividend to Eastern, a payment that included a $30,667 refund of taxes previously paid by Western. Under the general rules for dividends, the $80,000 dividend paid by Western would be included in the calculation of

Eastern's Net Income For Tax Purposes and deducted in the determination of its Taxable Income, with the net result that no Part I taxes would be paid on the $80,000. This would, in effect, allow retention of 80 percent of the investment income within the corporate group, a result that is contrary to the general concept of integration.

### The Solution

13-84. In order to correct this situation, a second application of Part IV tax is as follows:

> **Part IV Tax - Connected Companies** When a private corporation receives dividends from a connected private corporation that has received a dividend refund under ITA 129(1) as a result of paying the dividends, the recipient company is liable for a Part IV tax equal to its share of the refund received by the paying corporation. If the dividend paid is eligible for a full 38-1/3 percent of the dividend paid, the Part IV tax can also be expressed as 38-1/3 percent of the dividends received.
>
> However, the payor corporation may be earning both active business income and investment income. In such situations, if dividends reflect a distribution of both types of income, the dividend refund will not be at the full 38-1/3 percent rate. (See the Paragraph 13-92 example.) This is why the Part IV tax on dividends received from a connected corporation is expressed in terms of the recipient's share of the refund received by the paying corporation, not in terms of a specific rate.
>
> As was the case with the Part IV tax on portfolio dividends, this Part IV tax is refundable on the basis of 38-1/3 percent of dividends paid by the assessed corporation.

### Example Of Connected Corporation Dividends

13-85. Returning to the example presented in Paragraph 13-68, you will recall that Western has $100,000 in investment income and pays maximum dividends of $80,000 to Eastern. When the Part IV tax is taken into consideration, the tax consequences for the two companies are as follows:

| | |
|---|---|
| Investment Income Received By Western | $100,000 |
| Corporate Tax At 50-2/3 Percent (Including The ART) | ( 50,667) |
| Income Before Dividends | $ 49,333 |
| **Dividend Refund [($49,333 ÷ .61667) - $49,333]** | **30,667** |
| Dividends Paid To Eastern | $ 80,000 |

| | |
|---|---|
| Investment Income (Dividends Received From Western) | $80,000 |
| **Part IV Tax Payable (100% Of Western's Refund*)** | **( 30,667)** |
| Income Retained By Eastern | $49,333 |

*Because all of Western's income was from investments, Western's dividend refund is the full 38-1/3 percent of dividends paid. This means that Eastern's Part IV tax can also be calculated as 38-1/3 percent of the $80,000 in dividends received from Western.

13-86. As this simple example shows, after the application of the Part IV tax, the amount retained in Eastern is the same $49,333 that was retained in Western. This retention reflects a tax rate on the amount retained within the corporate group of 50-2/3 percent [($100,000 - $49,333) ÷ $100,000], about the same rate that would be paid by an individual taxpayer in the maximum federal/provincial tax bracket on the direct receipt of the $100,000 in investment income. Clearly, the application of Part IV tax has served to maintain integration in situations involving connected companies.

13-87. If Eastern decides to distribute the retained income to its shareholders, the results would be as follows:

| | |
|---|---|
| Income Retained By Eastern | $49,333 |
| **Dividend Refund [($49,333 ÷ .61667) - $49,333]** | **30,667** |
| Non-Eligible Dividend To Shareholders | $80,000 |

13-88. In effect, the $100,000 of investment income has passed through two corporations and into the hands of individual shareholders, subject to corporate taxes of only 20 percent. This has been accomplished, despite the fact that the initial level of corporate taxation was sufficiently high to discourage allocating investment income to a multi-level corporate structure.

13-89. Note, however, the effective corporate tax rate in this example is only 20 percent. It is for this reason that the Aggregate Investment Income of a CCPC is subtracted in the determination of Full Rate Taxable Income.

### Applicability

13-90. We would remind you again that the Part IV tax on dividends from a connected company is only applicable when the paying corporation has received a dividend refund. This means that dividends paid out of a corporation's Aggregate Investment Income or paid out of portfolio dividends received will be subject to Part IV tax. If the paying corporation was earning only active business income, no refund would be available when this after tax income was paid out as dividends. As a consequence, no Part IV tax would be assessed on the corporation receiving the dividend.

13-91. This result is consistent with the goals of integration in that, when a corporation is earning active business income that is taxed at the low small business rate, tax deferral is permitted on income that is retained in the corporation, and not paid out as dividends.

## Dividends Paid Out Of Mixed Income Of A Connected Corporation

13-92. In many cases, a corporation will be earning both investment income and active business income. This will result in a situation, unlike the example previously presented, where some part of the dividends paid by the corporation will be eligible for a refund, and the remainder will not. In this type of situation, the Part IV tax will not be equal to 38-1/3 percent of the dividends received. An example will make this point clear:

**EXAMPLE** Lower Ltd. declares and pays a dividend of $45,000. As a result of paying this dividend, the Company receives a dividend refund equal to $9,000 or 20 percent of the dividend. Upper Inc. owns 60 percent of the outstanding shares of Lower Ltd. and receives dividends of $27,000.

**ANALYSIS** In this case, the dividend refund is clearly less than 38-1/3 percent of the dividends paid, indicating that Lower's income is made up of a combination of investment income and other income. In this more realistic situation, the Part IV Tax Payable by Upper will be based on Upper's 60 percent share of the $9,000 dividend refund of Lower that resulted from paying the dividend. Upper's Part IV tax would be $5,400 [(60%)($9,000)].

### Exercise Thirteen - 5

**Subject:** Part IV Tax

Opal Ltd., a Canadian controlled private corporation, received the following amounts of dividends during the year ending December 31, 2019:

| | |
|---|---|
| Dividends On Various Portfolio Investments | $14,000 |
| Dividends From Emerald Inc. [(100%)($41,500)] | 41,500 |
| Dividends From Ruby Inc. [(30%)($60,000)] | 18,000 |

Opal Ltd. owns 100 percent of the voting shares of Emerald Inc. and 30 percent of the voting shares of Ruby Inc. The fair market value of the Ruby Inc. shares is equal to 30 percent of the fair market value of all Ruby Inc. shares. As a result of paying the $60,000 dividend, Ruby Inc. received a dividend refund of $15,000. Emerald Inc. received no dividend refund for its dividend payment.

Determine the amount of Part IV Tax Payable by Opal Ltd. as a result of receiving these dividends.

**SOLUTION available in print and online Study Guide.**

## Other Part IV Tax Considerations

13-93. The preceding material has dealt with the basic features of the Part IV tax on dividends received by private corporations. There are a few additional points to be made. First, you should note what kinds of dividends are not subject to Part IV tax. For a private or a subject company, the only dividends, besides capital dividends, that will not be subject to Part IV tax are those received from a connected corporation that does not get a dividend refund as a result of paying the dividend.

13-94. A second point is that ITA 186(1)(c) and (d) allows a corporation to use unabsorbed non-capital losses to reduce any Part IV tax. The Part IV tax otherwise payable can be reduced by 38-1/3 percent of any non-capital or farm losses claimed for this purpose. However, if this option is chosen, the corporation has effectively used a possible permanent reduction in future taxes to acquire a reduction of Tax Payable that could otherwise ultimately be refunded. This would only make sense in situations where the non-capital loss carry forward was about to expire, or where the company did not expect to have Taxable Income in the carry forward period. With the non-capital loss carry forward period set at 20 years, this is unlikely to be a very useful strategy.

# Designation Of Eligible Dividends

## Basic Concepts

### The Problem

13-95. We have previously discussed the importance of the distinction between eligible and non-eligible dividends (see Paragraph 13-13). Given the significant difference in the taxation of the two types of dividends, tax planners will clearly have an incentive to maximize the amount of dividends that can be designated as eligible.

13-96. We have also noted that, because of the availability of the small business deduction, most dividends declared by CCPCs will be non-eligible and most dividends declared by public companies will be designated as eligible.

13-97. Given this, it would be very convenient to have a rule that says that all taxable dividends paid by non-CCPCs are eligible dividends, while all dividends paid by CCPCs are non-eligible. Unfortunately, this simple dichotomy does not work. This reflects the fact that:

- some CCPCs may have a portion of their income taxed at full rates (e.g., active business income in excess of the annual business limit of $500,000), and
- some public companies may have a portion of their income taxed at favourable rates (e.g., a CCPC that goes public with a retained earnings balance that contains amounts that benefitted from the small business deduction).

### The Solution

13-98. To deal with the problem, a system is required that recognizes the need for different procedures to be applied to CCPCs vs. non-CCPCs. In simplified terms, the system that has been developed is as follows:

**CCPCs** It is assumed that, in general, dividends paid by CCPCs are non-eligible. However, to track components of their income that have been taxed at full corporate rates, CCPCs have a notional account referred to as a General Rate Income Pool (GRIP). The balance in this account provides a basis for paying eligible dividends. Note, however, as will be discussed later in this Chapter, the ability to obtain a refund on eligible dividends is limited by the balance in the corporation's Eligible Refundable Dividend Tax On Hand (Eligible RDTOH).

**Non-CCPCs** In general, non-CCPCs are comprised of public companies and private companies that are not Canadian controlled. For these companies, it is assumed that, in general, dividends paid are eligible. However, to track components of their income that have been taxed at low rates, they have to use a notional account referred to as a Low Rate Income Pool (LRIP). The balance in this account must be reduced to nil by the payment of non-eligible dividends prior to the payment of eligible dividends.

## CCPCs And Their GRIP

### Default Treatment

13-99. While individual CCPCs may have some amount of full rate taxable income, most of the income earned by such corporations will benefit either from the small business deduction or the refund procedures that we have discussed. Given this, the majority of dividends paid by most CCPCs will be non-eligible. For these corporations, the default assumption is that their dividends will be so classified.

13-100. However, it is still necessary to deal with the fact that, to the extent that a CCPC has full rate taxable income or has received eligible dividends, its dividends should benefit from the eligible dividend procedures. The mechanism to provide for this is the General Rate Income Pool (GRIP).

### General Rate Income Pool (GRIP)

13-101. The General Rate Income Pool is a notional account that is designed to track amounts of a CCPC's income that qualify as a basis for paying eligible dividends. As noted, the default treatment for CCPC dividends is to classify them as non-eligible. However, to the extent that there is a balance in the GRIP account of the corporation, CCPC dividends paid can be designated as eligible.

13-102. The GRIP balance is defined in ITA 89(1). It is a very complex definition that consists of an A component and a B component. The content of the B component involves such things as loss carry overs and other future events that may influence the current year. The application of this component goes beyond the scope of this text and will be given no consideration in any of our material. The A component is defined as follows (also available at the front of this text in "Rates And Other Data"):

$$\mathbf{A = C + D + E + F - G}\text{, where}$$

**C** is the CCPC's GRIP at the end of the preceding taxation year.

**D** is 72 percent of the CCPC's adjusted taxable income for the year.
Adjusted Taxable Income is regular Taxable Income, reduced by the amount eligible for the small business deduction and the lesser of the CCPC's Aggregate Investment Income and its Taxable Income for the year.

**E** is the amount of eligible dividends received by the CCPC during the year.

**F** involves a group of technical additions related to becoming a CCPC, amalgamations, and wind-ups.

**G** is the amount of eligible dividends paid during the ***preceding*** year, less the amount of any Excessive Eligible Dividend Designation (EEDD) made during the preceding year (see Paragraph 13-109).

13-103. Several comments on this formula are relevant at this point:

- The D component calculates a Taxable Income that is adjusted to eliminate the types of income for which CCPCs receive favourable tax treatment. As dividends are paid out of after tax funds, the residual income is multiplied by 72 percent, reflecting a notional federal/provincial tax rate of 28 percent.
- If a CCPC receives eligible dividends, the addition in E allows these dividends to retain that status on their flow through to the shareholders of the CCPC.
- Note that the balance is reduced, not by eligible dividends paid in the current year, but by eligible dividends paid in the preceding year.

13-104. A simple example will illustrate these provisions:

**EXAMPLE** Norgrave Ltd., a CCPC, had no GRIP balance at the end of 2017. During 2018, the Company received eligible dividends of $46,600 and designated $25,000 of its dividends paid as eligible. At the end of 2018, Norgrave has a GRIP of $46,600.

For 2019, Norgrave has Taxable Income of $225,000. This amount includes Aggregate Investment Income of $55,000. In addition, the Company receives eligible dividends during the year of $50,000.

In determining 2019 Tax Payable, the Company has a small business deduction of $28,500 [(19%)($150,000)]. During 2019, Norgrave pays dividends of $40,000, with $20,000 of this amount being designated as eligible.

**ANALYSIS** The 2019 ending balance in GRIP will be calculated as follows:

| | | |
|---|---|---|
| C - GRIP Balance At End Of 2018 | | $46,600 |
| D - Taxable Income | $225,000 | |
| Amount Eligible For The Small Business Deduction | ( 150,000) | |
| Aggregate Investment Income (Less Than Taxable Income) | ( 55,000) | |
| Adjusted Taxable Income | $ 20,000 | |
| Rate | 72% | 14,400 |
| E - Eligible Dividends Received | | 50,000 |
| G - Eligible Dividends Designated in 2018 | | ( 25,000) |
| GRIP At End Of 2019 | | $86,000 |

The eligible dividends paid during 2019 will be deducted from the GRIP in 2020.

## Exercise Thirteen - 6

**Subject:** GRIP Balance

Lanson Inc., a CCPC, had no GRIP balance at its year end on December 31, 2017. During 2018, the Company received eligible dividends of $35,000 and designated all of its $25,000 in dividends paid as eligible. At the end of 2018, Lanson has a GRIP of $35,000.

For 2019, Lanson has Taxable Income of $960,000. This amount includes net taxable capital gains of $65,000, mortgage interest received of $23,000, and a net capital loss carry forward deduction of $14,000. In addition, the Company receives eligible dividends during the year of $85,000. In determining 2019 Tax Payable, the Company has a small business deduction of $42,750. During 2019, Lanson pays dividends of $78,000, with $42,000 of this amount being designated as eligible. Determine the Company's GRIP balance at the end of 2019.

**SOLUTION available in print and online Study Guide.**

## Non-CCPCs And Their LRIP

### *Low Rate Income Pool (LRIP)*

13-105. For non-CCPCs, their income will generally be taxed at full corporate rates. This means that, in general, their dividends can be designated as eligible. However, in some situations, a non-CCPC may have balances that have not been taxed at full corporate rates. This could include amounts of income retained by a CCPC before it became a public company, as well as non-eligible dividends received from a CCPC.

13-106. Such balances will be allocated to a notional account referred to as a Low Rate Income Pool (LRIP). This account, defined in ITA 89(1), is similar to the GRIP account in that it is used to track certain types of income. However, the two accounts serve different purposes:

- The GRIP account is used to track balances that can be used by a CCPC as the basis for designating eligible dividends. To the extent that a GRIP balance is present, CCPC dividends can be designated as eligible until such time as the balance is exhausted. Note, however, the presence of a GRIP balance does not require that dividends be designated as eligible. Designation as eligible is at the discretion of the corporation.
- The LRIP account is used to track balances that have not been subject to full corporate tax rates. When an LRIP balance is present, any dividends paid by the corporation will be considered non-eligible. Stated alternatively, a corporation with a positive LRIP balance cannot designate any of its dividends as eligible until the LRIP balance is exhausted. In this situation, the corporation has no discretion.

13-107. The definition of the LRIP balance, as found in ITA 89(1) is as follows:

**(A + B + C + D + E + F) - (G + H)**, where

**A** is the non-CCPCs LRIP at the end of the preceding year.
**B** is the amount of non-eligible dividends received by the non-CCPC from a corporation resident in Canada.
**C** is a group of technical additions related to corporate reorganizations.
**D** is an adjustment for a non-CCPC that was a CCPC in some preceding year.
**E** is an adjustment for a non-CCPC that was a credit union in some preceding year.
**F** is an adjustment for a non-CCPC that was an investment company in some preceding year.

**G** is the amount of taxable dividends, other than eligible dividends, paid by the non-CCPC during the year.

**H** is the amount of any EEDD made by the non-CCPC during the year.

13-108. A simple example will serve to illustrate this definition.

**EXAMPLE** At the end of 2018, Ovamp Ltd. has an LRIP balance of $450,000. During 2019, the Company receives non-eligible dividends from a CCPC in the amount of $225,000. During 2019, the Company pays dividends of $360,000.

**ANALYSIS** Given the presence of a positive LRIP balance in excess of the total dividends paid, none of the Ovamp dividends could be designated eligible.

## Part III.1 Tax On Excessive Eligible Dividend Designations

### *Calculation*

13-109. The enhanced dividend tax credit procedures are available on any dividend that the paying corporation has designated as eligible. This raises the possibility that a corporation might designate a dividend as eligible under circumstances where such a designation is not appropriate (e.g., a CCPC designating a dividend as eligible when it has no balance in its GRIP at the end of the year). To discourage this, the government has a Part III.1 tax on what is referred to as an Excessive Eligible Dividend Designation (EEDD).

13-110. If the EEDD is inadvertent, the Part III.1 tax is equal to 20 percent of the excess amount. In these circumstances, Part III.1 provides for an election that will allow the taxpayer to effectively undo the designation.

13-111. If the CRA concludes that the EEDD reflects an attempt to artificially manipulate either a GRIP or an LRIP, the Part III.1 tax rate goes to 30 percent. In addition, there are two other consequences:

- The tax applies to the entire dividend, not just the EEDD.
- No election is available to undo the excessive election.

13-112. In order to appropriately track all dividend payments, any resident Canadian corporation that pays a taxable dividend is required to file a return for the year under Part III.1.

13-113. ITA 89(1) defines EEDD differently for CCPCs and non-CCPCs. These definitions will be considered separately in the following material.

## EEDD For A CCPC

13-114. If a CCPC designates an amount of eligible dividends that is in excess of its GRIP at the end of the year, it will be considered an EEDD and be subject to Part III.1 tax.

> **EXAMPLE** At its December 31, 2018 year end, Sandem Inc., a CCPC, has a GRIP of \$45,000. It paid no dividends in 2018. During 2019, the Company pays dividends of \$100,000, of which \$60,000 are designated as eligible. There are no additions to the Company's GRIP during 2019.
>
> **ANALYSIS** The Company has an EEDD of \$15,000 (\$60,000 - \$45,000). Provided the CRA believes that this was an inadvertent result, this amount will be subject to a Part III.1 tax of 20 percent on the excess of \$15,000. There is also the possibility of electing to have the EEDD treated as a non-eligible dividend.
>
> If the CRA concludes that the EEDD was a deliberate attempt to manipulate the Company's GRIP, an additional 10 percent is added to the Part III.1 tax. In addition, the applicable 30 percent tax is assessed on the entire eligible amount of \$60,000, not just the \$15,000 EEDD amount and no election is available to undo the excessive election.

## EEDD For A Non-CCPC

13-115. In somewhat simplified terms, an EEDD for a non-CCPC is equal to the lesser of its eligible dividends paid and its LRIP at the time the dividend is paid. For example, if a non-CCPC paid an eligible dividend of \$50,000 at a point in time that its LRIP was equal to \$40,000, the EEDD would be \$40,000. Note that, unlike the situation with EEDDs for CCPCs, where the amount is based on the end of year balance of the GRIP, the EEDD for a non-CCPC is based on the balance of the LRIP at the point in time when the eligible dividend is paid.

13-116. A simple example will illustrate these provisions:

> **EXAMPLE** Victor Ltd., a Canadian public company, receives \$42,000 in non-eligible dividends from a CCPC on June 15, 2019. Its LRIP has a balance of nil prior to this. On September 23, 2019, Victor pays dividends of \$100,000, with \$30,000 of this amount being designated as eligible.
>
> **ANALYSIS** As at September 23, 2019, the balance in the LRIP would be \$42,000. The lesser of this amount and the eligible dividend would be \$30,000 and this would be the amount of the EEDD.
>
> This result seems somewhat counter-intuitive in that a non-eligible dividend was paid in an amount sufficient to eliminate the LRIP. However, the legislation is clear that the LRIP is measured at a particular point in time and, if an eligible dividend is paid when there is a positive balance in this account, it creates an EEDD. We would note that this situation could have been avoided had the non-eligible dividend been paid before, even by one day, the payment of the eligible dividend.

Provided there were no further dividend transactions, the LRIP balance at the end of the year would be nil as the payment of $70,000 in non-eligible dividends would have eliminated the $42,000 balance created by the non-eligible dividends received.

With respect to the Part III.1 tax, a tax of 20 percent would normally be assessed on the EEDD of $30,000. However, if the CRA concludes that a deliberate attempt to manipulate the LRIP was involved, the tax rate will be increased to 30 percent.

## A Final Word On Eligible Dividends

13-117. You should be aware that the preceding is a fairly simplified version of the provisions related to eligible dividends and their designation. The complete legislation is far more complex, dealing with a number of transitional situations, changes in a corporation's classification, as well as problems associated with corporate reorganizations. However, we feel that this version of the material is appropriate for an introductory text in taxation.

# Refundable Dividend Tax On Hand (RDTOH)

## Background

### *Pre-2019*

13-118. As will be discussed in the material which follows, the RDTOH is an account that is used to track refundable taxes paid during the year. The balance is reduced by refunds claimed in the previous year, resulting in a balance that can be refunded when dividends are paid to shareholders.

13-119. Prior to 2019, each private corporation had a single RDTOH account. All refundable taxes, both Part I and Part IV were added to this account. The resulting balance then provided a limit on the amount of dividend refund that could be claimed. As will be discussed later in this section, the dividend refund was limited to the lesser of:

- 38-1/3 percent of taxable dividends paid; and
- the balance in the RDTOH.

13-120. As was noted in the previous section of this Chapter, the amount of dividends that could be designated by a CCPC as eligible is limited to the balance in the corporation's GRIP account. (Note that private companies that are not Canadian controlled are not able to have a GRIP account.) Prior to 2019, any balance that was in the corporation's single RDTOH was available for a dividend refund. The entire balance could be used for a dividend refund on either eligible or non-eligible dividends paid.

### *2019 And Subsequent Years*

13-121. As has been noted, the government believes that private corporations have an unfair advantage in their ability to accumulate large portfolios of passive investments using income that has been retained after being taxed at low small business rates. Given this concern, legislation has been put in place that will make this process less attractive.

13-122. We introduced the first of these legislative provisions in Chapter 12. As discussed in that Chapter, CCPCs that have ADJUSTED Aggregate Investment Income for the previous year in excess of $50,000 will see their annual business limit for the small business deduction ground down, with the full amount of the limit disappearing when ADJUSTED Aggregate Investment Income for the previous year reaches $150,000. As noted in Chapter 12, the Department Of Finance has indicated their belief that only about 3 percent of the companies claiming the small business deduction will be affected.

13-123. A second, much more pervasive measure, is directed towards limiting the amount of dividend refunds that can be paid on dividends designated as eligible. This involves dividing the RDTOH account into two separate balances. We will refer to these two balances as the Eligible RDTOH and the Non-Eligible RDTOH. When dividends are designated as eligible, a dividend refund is only available to the extent of the balance in the corporation's

Eligible RDTOH. This means that, if dividends are designated as eligible when there is no balance in the corporation's Eligible RDTOH, no dividend refund is available. Stated alternatively, if a corporation maximizes the amount of dividends that the GRIP balance would allow to be designated as eligible, they may not be able to access all of the refundable taxes they have paid.

13-124. What this means is that, in order to access all of the refundable taxes paid, a corporation may have to pay non-eligible dividends, even in situations where a GRIP balance would allow the designation of eligible dividends. This is very important in that individual tax rates are significantly higher on non-eligible dividends than is the case with eligible dividends. While the amount varies from province to province, the average difference is about 8 percentage points. Despite the favourable taxation of eligible dividends, this change will clearly discourage the use of eligible dividends in situations where the designation results in a less than maximum dividend refund.

13-125. To implement this new regime, a transitional provision is required. This provision is required in order to divide the existing single RDTOH balances into eligible and non-eligible components. Prior to providing definitions of the content of the new eligible RDTOH and non-eligible RDTOH accounts, we will present the procedures that are used in this transitional provision.

## Transitional Provision

13-126. At December 31, 2018, most private corporations will have a single RDTOH balance. In addition, many of these private corporations who are CCPCs will have a GRIP balance. The goal of the relevant transitional provision is to divide the single RDTOH balance into eligible (if any) and non-eligible components.

> **BYRD/CHEN NOTE** Note that our discussion of this transitional provision and the related examples will be based on corporations with a December 31 year end. The use of other taxation years significantly complicates the application of this provision and, in our opinion, is not appropriate for an introductory text such as this.

13-127. Under ITA 129(5), the January 1, 2019 Eligible RDTOH is defined as the lesser of:

- The January 1, 2019 balance of the single RDTOH account. Note that this balance is the December 31, 2018 balance, reduced by the dividend refund for 2018.
- 38-1/3 percent of the January 1, 2019 GRIP balance. Similar to the RDTOH balance, this balance is the December 31, 2018 balance, reduced by eligible dividends designated in 2018. This amount reflects the dividend refund that would be available if the maximum designation of eligible dividends were to be made.

13-128. Any excess of the single RDTOH account over 38-1/3 percent of the GRIP balance will become the transitional Non-Eligible RDTOH. In the absence of a GRIP balance, the transitional Eligible RDTOH will be nil.

**EXAMPLE** Canotek Ltd. is a CCPC. On December 31, 2018, the balance in its RDTOH account is $156,000, while the balance in its GRIP account is $240,000. During 2018, the corporation claimed a dividend refund of $62,000 and designated eligible dividends of $126,000.

**ANALYSIS** The Eligible RDTOH would be the lesser of:

- $94,000 ($156,000 - $62,000); and
- $43,700 [(38-1/3%)($240,000 - $126,000)].

Based on this, the Eligible RDTOH would be $43,700, leaving $50,300 ($94,000 - $43,700) as the transitional Non-Eligible RDTOH.

## Exercise Thirteen - 7

**Subject:** RDTOH Transitional Provision

Brok Ltd. is a CCPC that uses December 31 as its taxation year end. On December 31, 2018, the corporation had an RDTOH balance of $153,333. Its dividend refund for 2018 was $76,666. Determine the January 1, 2019 transitional amounts for the Eligible RDTOH and the Non-Eligible RDTOH based on the information in each of the following independent cases.

**Case 1** On December 31, 2018, Brok has no GRIP balance.

**Case 2** On December 31, 2018, Brok has a GRIP balance of $300,000. During 2018, the corporation designated $200,000 of dividends paid as eligible.

**Case 3** On December 31, 2018, Brok has a GRIP balance of $500,000. During 2018, the corporation designated $200,000 of dividends paid as eligible.

**SOLUTION available in print and online Study Guide.**

13-129. Immediately subsequent to the application of this transitional rule, the Eligible RDTOH balance will be equal to, or less than, 38-1/3 percent of the GRIP balance. While this ensures that a dividend refund will be available to the extent of any eligible dividends that are supported by the corporation's GRIP balance present at the time of transition, there is no further connection between the determination of the GRIP balance and the Eligible RDTOH balance.

13-130. In the transition year and in subsequent years, it is unlikely that the Eligible RDTOH will continue to be equal to 38-1/3 percent of the GRIP balance. If the Eligible RDTOH falls below 38-1/3 percent of the GRIP balance, the new rules do not prevent the designation of eligible dividends. In fact, the new rules do not alter the determination of the GRIP balance. However, if the Eligible RDTOH balance is less than 38-1/3 percent of the GRIP balance, the full 38-1/3 percent dividend refund will not be available on all, or part of, the dividends designated as eligible.

## Refundable Portion Of Part I Tax Payable

### *The Problem*

13-131. When we define both the eligible and non-eligible RDTOH accounts, we will have to add the amount of both Part I and Part IV taxes that are eligible for a refund. While there are issues with respect to which RDTOH account will be allocated the Part IV tax, there is no question as to the total addition. It is simply the amount of Part IV tax paid for the year.

13-132. The situation is more complex with the Part I tax in that only a part of the amount paid is refundable. In simplified terms, only the Part I tax that is related to Aggregate Investment Income is eligible for a refund. However, the Tax Payable on this income can be reduced by deductions in the determination of Taxable Income (e.g., charitable contributions) or by credits against Tax Payable (e.g., foreign tax credits). Given this, it is necessary to take the amounts of Taxable Income and Tax Payable into consideration when determining the refundable portion of Part I tax. This is accomplished in the ITA 129(4) definition of Non-Eligible RDTOH. This definition places constraints on the refundable amount by indicating that it will be the least of three amounts:

- ITA 129(4)(a)(i) An amount based on Aggregate Investment Income.
- ITA 129(4)(a)(ii) An amount based on Taxable Income.
- ITA 129(4)(a)(iii) An amount based on Tax Payable.

13-133. We will give detailed attention to each of these constraints in the Paragraphs that follow.

### Investment Income Constraint - ITA 129(4)(a)(i)

13-134. The basic amount of Part I tax that should be considered refundable is based on the amount of Aggregate Investment Income for the year:

**ITA 129(4)(a)(i)** the amount determined by the formula

**A - B**, where

**A** is 30-2/3 percent of the corporation's Aggregate Investment Income for the year, and

**B** is the amount, if any, by which the foreign non-business income tax credit exceeds 8 percent of its foreign investment income for the year.

13-135. Aggregate Investment Income is as defined in ITA 129(4). As indicated previously, Aggregate Investment Income is the sum of:

- Net taxable capital gains for the year, reduced by any net capital loss carry overs deducted during the year.
- Income from property, reduced by any property losses. Dividends that are deductible in computing the corporation's Taxable Income are excluded.

13-136. These amounts do not include interest or rents that are incidental to the corporation's efforts to produce active business income. As noted in Chapter 12, these amounts would be considered active business income. Note, however, the definition does include both Canadian and foreign sources of the types of income listed.

13-137. If the corporation has no foreign source investment income, the ITA 129(4)(a)(i) amount is simply 30-2/3 percent of Aggregate Investment Income. The RDTOH legislation is based on the assumption that the federal/provincial rate on investment income, before any dividend refund, is 50-2/3 percent. This assumption is within the range of current combined federal/provincial rates on the investment income of private companies.

13-138. With respect to foreign non-business income, the RDTOH legislation is based on the assumption that the Canadian tax rate on this foreign income is 38-2/3 percent (38% - 10% + 10-2/3%). Reflecting this assumption, the B component in the ITA 129(4)(a)(i) formula subtracts any amount of foreign tax credit that is in excess of 8 percent of foreign investment income for the year.

13-139. The basic idea here is that a foreign tax credit of 8 percent will reduce the Canadian taxes paid to 30-2/3 percent (38-2/3% - 8% = 30-2/3 percent, the rate applicable to the refund). If the foreign tax credit exceeds 8 percent of the foreign investment income, the Canadian taxes paid would be less than the potential refund of 30-2/3 percent. In other words, without the 8 percent subtraction, the Canadian government would be providing a refund that is larger than the amount of Canadian tax paid on the foreign investment income.

**EXAMPLE** A CCPC earns $50,000 in foreign investment income. The government in the foreign jurisdiction withholds 15 percent of this amount and, as a consequence, the company receives a foreign non-business tax credit of $7,500.

**ANALYSIS** At the assumed rate of 38-2/3 percent, Canadian tax on this income would be $11,833 [(38-2/3%)($50,000) - $7,500]. This results in a Canadian tax rate on this income of only 23.7 percent ($11,833 ÷ $50,000). Without some type of adjustment, the refundable taxes on this $50,000 of income would be at a rate of 30-2/3% and would equal $15,333 [(30-2/3%)($50,000)], $3,500 more than the $11,833 in Canadian taxes that would be paid. This is clearly not appropriate.

To correct this situation, the excess of the foreign non-business income tax credit over 8 percent of the foreign investment income is subtracted from the 30-2/3 percent refund on the foreign investment income. The 8 percent reflects the difference between the notional rate of 38-2/3 percent and the refund rate of 30-2/3 percent.

In our example, the calculations would be as follows:

| | | |
|---|---|---|
| 30-2/3 Percent Of Foreign Investment Income | | $15,333 |
| Deduct Excess Of: | | |
| Foreign Non-Business Tax Credit | ($7,500) | |
| Over 8% Of Foreign Investment Income [(8%)($50,000)] | 4,000 | ( 3,500) |
| **ITA 129(4)(a)(i)** | | **$11,833** |

This procedure has, in effect, reduced the amount of the refund to $11,833. As calculated at the beginning of this analysis, this is equal to the notional amount of Canadian taxes paid on the foreign investment income.

### Taxable Income Constraint - ITA 129(4)(a)(ii)

13-140. A further problem with respect to determining the refundable portion of Part I tax payable is that the corporation's Taxable Income may include amounts that are not taxed at full corporate rates (e.g., amounts eligible for the small business deduction). Further, Taxable Income may be reduced by such items as non-capital loss carry overs to a level that is less than the amount of investment income on which ITA 129(4)(a)(i) would provide a refund. To deal with this, the refundable portion of the Part I tax is limited as follows:

**ITA 129(4)(a)(ii)** 30-2/3 percent of the amount, if any, by which the corporation's taxable income for the year exceeds the total of:

**A** the amount eligible for the small business deduction;
**B** (100 ÷ 38-2/3) of the tax credit for foreign non-business income; and
**C** 4 times the tax credit for foreign business income.

13-141. Component B is designed to remove foreign investment income that is not taxed because of the foreign non-business tax credit. The elimination is based on the assumption that it is taxed at a notional rate of 38-2/3 percent (38-2/3 ÷ 100). In similar fashion, Component C is designed to remove foreign business income that is not taxed because of the foreign business income tax credit. The elimination here is based on the assumption that this type of income is taxed at a notional rate of 25 percent (1 ÷ 4). The factor of 4 in Component C is actually the result of a more complex calculation. See Chapter 12, Paragraph 12-91 for details of this calculation explained in the context of the small business deduction formula.

### Tax Payable Constraint - ITA 129(4)(a)(iii)

13-142. A final issue here relates to the fact that the dividend refund could exceed the corporation's actual Tax Payable for the year. This could happen if, for example, the company had large amounts of tax credits for scientific research and experimental development. To deal with this issue, the refundable portion of Part I tax is limited as follows:

**ITA 129(4)(a)(iii)** the corporation's federal tax for the year payable under this Part (Part I).

### Formula For Part I Tax Addition To RDTOH

13-143. To summarize, the addition to the RDTOH for Part I tax (also available in the front of this text under "Rates And Other Data") is the least of:

**ITA 129(4)(a)(i)** 30-2/3 percent of Aggregate Investment Income, reduced by the excess, if any, of foreign non-business income tax credits over 8 percent of foreign investment income.

**ITA 129(4)(a)(ii)** 30-2/3 percent of the amount, if any, by which Taxable Income exceeds the sum of:

- the amount eligible for the small business deduction,
- (100 ÷ 38-2/3) of the foreign non-business tax credit, and
- 4 times the foreign business tax credit.

**ITA 129(4)(a)(iii)** Part I tax payable.

## Exercise Thirteen - 8

**Subject:** Refundable Part I Tax

Debut Inc. is a Canadian controlled private corporation. During the taxation year ending December 31, 2019, Debut Inc. has the following amounts of property income:

| | |
|---|---|
| Dividends From Portfolio Investments | $22,000 |
| Foreign Non-Business Income (Net Of 5 Percent Withholding) | 14,250 |
| Capital Gains | 38,250 |
| Net Rental Income | 6,500 |
| Interest Income On Ten Year Bond | 9,200 |

The Company's Net Income For Tax Purposes is $121,825. The only deductions in the calculation of Taxable Income are the dividends on portfolio investments and a net capital loss carry forward of $9,000 [(1/2)($18,000)]. A $9,500 small business deduction and a foreign tax credit of $750 served to reduce Tax Payable. Assume that the Company's Part I Tax Payable has been correctly determined to be $19,536. Determine the refundable amount of Part I tax for 2019.

**SOLUTION available in print and online Study Guide.**

## RDTOH Balances Defined

### *Eligible RDTOH Defined*

13-144. The definition for the Eligible RDTOH account is found in ITA 129(4). In somewhat simplified terms, this definition is as follows:

**BEGINNING BALANCE** For 2019, the calculation would begin with the transitional amount that we have previously discussed (Paragraph 13-126). For subsequent years, it would begin with the balance in the Eligible RDTOH at the end of the previous taxation year.

**ADDITIONS** In somewhat simplified terms, two items would be added to this beginning balance:

- Part IV taxes paid on eligible dividends from non-connected taxable Canadian corporations. These are commonly referred to as portfolio dividends.
- Part IV taxes paid on eligible dividends from connected corporations to the extent that such dividends included a refund from the paying corporation's Eligible RDTOH.

**DEDUCTION** Deducted from this total would be any dividend refund claimed from the Eligible RDTOH account in the previous taxation year. For 2019, this deduction is reflected in the transitional RDTOH balance and will not be deducted again.

13-145. It is important to note what is missing here. Prior to 2019, Part I refundable taxes were included in the single RDTOH account and could be used for a dividend refund on eligible dividends. This is no longer the situation.

13-146. As we shall see in our discussion of the Non-Eligible RDTOH account, all of the Part I refundable taxes are added to the Non-Eligible RDTOH account. This means that they can only be refunded through the payment of non-eligible dividends. We would remind you that Shareholders who are individuals pay considerably higher rates of tax on non-eligible dividends when compared to eligible dividends. This represents a significant change in tax policy.

### *Non-Eligible RDTOH Defined*

13-147. The definition of the Non-Eligible RDTOH account is also found in the ITA 129(4). Again, in somewhat simplified terms, it is as follows:

**BEGINNING BALANCE** As was the case with the Eligible RDTOH, for 2019, the beginning balance of the Non-Eligible RDTOH is the transitional amount that we have previously discussed. For subsequent years, it would begin with the balance in the Non-Eligible RDTOH at the end of the previous taxation year.

**ADDITIONS** There are three items that are added to the Non-Eligible RDTOH beginning balance:

- All of the Part I refundable tax for the year, determined as per the calculations discussed beginning at Paragraph 13-130.
- Part IV taxes paid on non-eligible dividends from connected corporations to the extent that such dividends included a refund from the paying corporation's Non-Eligible RDTOH.
- Part IV taxes paid on non-eligible dividends from non-connected taxable Canadian corporations. The situations where this would be applicable would be rare.

**DEDUCTION** Deducted from this total would be any dividend refund claimed from the Non-Eligible RDTOH account in the previous taxation year. For 2019, this deduction is reflected in the transitional RDTOH and will not be deducted again.

13-148. As you can see in the preceding paragraph, all of the Part I refundable taxes are added to the Non-Eligible RDTOH. This means that these taxes can only be recovered through the payment of non-eligible dividends. In contrast to the results when there was only a single RDTOH account, Part I refundable taxes cannot be recovered on the payment of eligible dividends.

### An Important Difference

13-149. While this cannot be explained fully until we look at the legislative provision for dividend refunds, there is a significant difference in the use of the two RDTOH accounts. With respect to eligible dividends, a refund is only available to the extent that there is a balance in the Eligible RDTOH. No part of the Non-Eligible RDTOH can be used for a refund related to eligible dividends.

13-150. The situation is different with respect to non-eligible dividends. While refunds on these dividends must first come out of the Non-Eligible RDTOH, if the 38-1/3 percent of the non-eligible dividends exceed the balance in that account, the Eligible RDTOH can be accessed to bring the total refund up to the required 38-1/3 percent of dividends paid.

13-151. As will be illustrated in the next section of this Chapter, corporations may be faced with a choice between maximizing the amount of eligible dividends (more favourably taxed for individuals) and recovering all of the refundable taxes that have been paid. While shareholders receiving eligible dividends pay about 8 percentage points less in taxes than on the receipt of non-eligible dividends, giving up the dividend refund on such dividends would be even more costly to the dividend paying corporation.

### Losses Used To Reduce Part IV Taxes

13-152. We have noted the possibility that Part IV taxes paid could be used to reduce non-capital and farm losses. To the extent that they are used for this purpose, they are not added to either RDTOH balance. This raises the question of how to allocate any remaining balance that is available. ITA 129(4.1) and (4.2), provide guidance on this allocation process. We do not believe that this is a common enough transaction to warrant coverage in a general text such as this.

## The Dividend Refund

### Dividend Refund On Eligible Dividends

13-153. When a CCPC declares dividends, an amount can be designated as an eligible dividend to the extent there is a balance in the corporation's GRIP account. The refund on these eligible dividends will then be the lesser of:

- 38-1/3% of the total of all eligible dividends paid by it in the year; and
- the end of year balance in the corporation's Eligible RDTOH.

13-154. A simple example will serve to illustrate this determination:

**EXAMPLE** Divor Ltd. is a CCPC with a December 31 year end. In 2019, after applying the required transitional provision, the corporation has an Eligible RDTOH of $38,333 (38-1/3 percent of its $100,000 GRIP balance). The transitional allocation to the Non-Eligible RDTOH is $76,667 [the balance in its single RDTOH account was $115,000 ($38,333 + $76,667)]. During 2019, the corporation pays dividends of $70,000, all of which are designated as eligible.

**ANALYSIS** As the GRIP balance is $100,000, there is no problem with designating all of the $70,000 in dividends as eligible. The refund is $26,833, the lesser of:

- $26,833 [(38-1/3%)($70,000)]; and
- $38,333, the balance in the Eligible RDTOH account at the end of the year.

The lesser figure would be $26,833, leaving $11,500 ($38,333 - $26,833) in the Eligible RDTOH account after the dividend refund has been subtracted in the following year. There would also be a $30,000 ($100,000 - $70,000) balance in the GRIP account after the 2019 eligible dividends paid have been subtracted in the following year.

### *Dividend Refund On Non-Eligible Dividends*

13-155. If the amount of dividends paid during the year exceed the amount that is designated as eligible, the excess will be a non-eligible dividend. The refund here consists of two components. The purpose of Component 2 is to allow access to the Eligible RDTOH for dividend refunds on the payment of non-eligible dividends if there is no balance left in the Non-Eligible RDTOH.

**Component 1** The lesser of:

- 38-1/3% of the total of all non-eligible dividends paid by it in the year; and
- the end of year balance in the corporation's Non-Eligible RDTOH.

**Component 2** If 38-1/3% of the non-eligible dividends paid in the year exceeds the balance in the Non-Eligible RDTOH, this Component 2 is the lesser of:

- the amount of the excess; and
- any balance that remains in the Eligible RDTOH after subtracting the dividend refund on eligible dividends designated.

If there is no excess, this Component is nil.

13-156. An example will serve to illustrate this calculation.

**EXAMPLE** At the beginning of 2019, Lexy Ltd. has a GRIP balance (ending 2018 balance, less eligible dividends designated in 2018) of $300,000. The pre-transition balance in Lexy's RDTOH account was $191,667 (ending 2018 balance, less the 2018 refund). To recover the full amount of this balance will require dividends of $500,000 [$191,667 = (38-1/3%)($500,000)].

The transitional balance in the Eligible RDTOH is $115,000 [(38-1/3%)($300,000)] and the transitional balance in the Non-Eligible RDTOH is $76,667 ($191,667 - $115,000). There were no additions to either balance during 2019, or to the corporation's GRIP balance.

During 2019, Lexy paid dividends of $500,000, with $300,000 of this amount being designated as eligible.

**ANALYSIS** The dividend refund on the $300,000 of eligible dividends is $115,000. This is equal to 38-1/3 percent of the $300,000 of eligible dividends paid and the balance in the Eligible RDTOH.

The dividend refund on the non-eligible dividends is $76,667. This is equal to 38-1/3 percent of the $200,000 ($500,000 - $300,000) of non-eligible dividends paid and the balance in the Non-Eligible RDTOH. As there is no excess of 38-1/3 percent of the non-eligible dividends paid over the end of year balance in the Non-Eligible RDTOH, Component 2 is equal to nil.

### Exercise Thirteen - 9

**Subject:** Dividend Refund

Alesia Ltd. is a Canadian controlled private corporation with a taxation year that ends on December 31. Prior to the application of the transitional rule, the balance in the corporation's single RDTOH account was $230,000 (ending 2018 balance, less the 2018 refund). The balance in the GRIP account was $350,000 (ending 2018 balance, less eligible dividends designated in 2018).

Based on these totals the transitional Eligible RDTOH would be $134,167 [(38-1/3%)($350,000)] and the balance in the transitional Non-Eligible RDTOH would be $95,833 ($230,000 - $134,167).

During 2019, there were no additions to either RDTOH account. During 2019, the corporation paid dividends of $600,000. Only $200,00 of these dividends were designated as eligible.

Determine the amount of the dividend refund on the payment of (1) the eligible dividends and (2) the non-eligible dividends.

**SOLUTION available in print and online Study Guide.**

**We suggest you work Self Study Problem Thirteen-2, 3, 4, and 5 at this point.**

## Economic Impact Of Changes

### *The Impact Illustrated*

13-157. The 2019 transition results in an Eligible RDTOH that is equal to 38-1/3 percent of the GRIP balance. Because of this, it is difficult to illustrate the impact of these changes that can arise in subsequent years. As a result, we will use an example based on 2020 amounts.

**EXAMPLE** The following information relates to Sarco Inc., a CCPC with a December 31 year end:

| | |
|---|---:|
| • December 31, 2020 GRIP | $1,000,000 |
| • December 31, 2020 Eligible RDTOH | 76,667 |
| • December 31, 2020 Non-Eligible RDTOH | 306,667 |

The combined RDTOH is $383,334 ($76,667 + $306,667). To recover the full amount of refundable taxes that have been paid, a dividend of $1,000,000 must be paid ($383,334 ÷ 38-1/3%). Determine the tax consequences related to each of the following alternatives.

**Alternative 1** Sarco pays a dividend of $1,000,000, with the entire amount being designated as eligible. Non-eligible dividends would be nil.

**Alternative 2** Sarco pays a dividend of $1,000,000, with none of the amount being designated as eligible, i.e., eligible dividends would be nil.

**Alternative 3** Sarco pays a dividend of $1,000,000, with $200,000 of the total paid designated as eligible.

**ANALYSIS ALTERNATIVE 1** $1,000,000 is the maximum amount that can be designated as eligible. If this approach is used, the GRIP balance will be eliminated. However, the refund will only be $76,667, the balance in the Eligible RDTOH. In the absence of non-eligible dividends, Sarco will not have access to the Non-Eligible RDTOH as a source for a dividend refund.

**ANALYSIS ALTERNATIVE 2** Unlike the situation with Alternative 1, where the Non-Eligible RDTOH could not be used for a refund on eligible dividends, the refund legislation allows access to the Eligible RDTOH, despite the fact that no eligible dividends were paid. Specifically, in this case, the refund on the non-eligible dividends would be calculated as follows:

- **Component 1** This amount is $306,667, the lesser of $383,333 [(38-1/3%)($1,000,000)] and $306,667, the balance in the Non-Eligible RDTOH.
- **Component 2** This amount is $76,666, the excess of 38-1/3 percent of the non-eligible dividends paid over the balance in the Non-Eligible RDTOH ($383,333 - $306,667).

This provides a total refund of $383,333 ($306,667 + $76,666), the full amount of the refundable taxes paid.

**ANALYSIS ALTERNATIVE 3** The dividend refund on the eligible dividends would be $76,667. This amount is 38-1/3 percent of the $200,000 in eligible dividends paid and the balance in the Eligible RDTOH. The refund on the non-eligible dividends paid would be $306,667. This amount is 38-1/3 percent of the $800,000 in non-eligible dividends paid and the balance in the Non-Eligible RDTOH. As in Alternative 2, the total refund is $383,333 (with a $1 rounding error).

**SUMMARY** These results can be summarized as follows:

| | Case 1 | Case 2 | Case 3 |
|---|---|---|---|
| Eligible Dividends Paid | $1,000,000 | Nil | $200,000 |
| Non-Eligible Dividends Paid | Nil | $1,000,000 | 800,000 |
| Total Dividend Refund | 76,667 | 383,333 | 383,333 |
| January 1, 2021: | | | |
| GRIP Balance | Nil | 1,000,000 | 800,000 |
| Eligible RDTOH | Nil | Nil | Nil |
| Non-Eligible RDTOH | 306,667 | Nil | Nil |

13-158. What this example illustrates is that there may be situations where none of the refund alternatives is completely satisfactory. Alternative 1 maximizes the amount of dividends designated as eligible, a very desirable result from the point of view of the shareholders. However, it leaves unrecovered refundable taxes of $306,667. Without this refund, the corporate taxes on the pre-dividend income would be around 50 percent. When this is combined with the taxes on the dividend distribution paid by individual shareholders, the overall tax rate could exceed 75 percent.

13-159. Alternative 2 has the advantage of recovering all of the refundable taxes. However, shareholders will be taxed on non-eligible dividends only, rather than on the more favourably taxed eligible dividends.

13-160. Alternative 3 improves on Alternative 2 in that, while recovering all of the refundable taxes paid, some of the dividends paid have been designated as eligible. While this is likely the best of the three alternatives, it still leaves an $800,000 balance in the GRIP balance, with no balance in the Eligible RDTOH to provide for a refund on any future dividends designated as eligible.

13-161. You should note that this would not have been a problem under the old pre-2019 RDTOH system. With a single RDTOH balance, the full $1,000,000 of dividends could have been designated as eligible, while still recovering all of the refundable taxes paid.

### Conclusion

13-162. A variety of other results are possible, depending on the relationships that exist between the GRIP balance, the Eligible RDTOH balance, and the Non-Eligible RDTOH. However, the preceding example is sufficient to make it clear that the 2019 changes have made it less desirable to use a CCPC to accumulate passive investments.

## Example Of RDTOH Calculations

13-163. The following simplified example illustrates the refundable tax calculations. In the separate Study Guide which accompanies this text, there is a completed corporate tax return in Chapter 13 which includes an additional illustration of the RDTOH account.

**EXAMPLE** Fortune Ltd. is a Canadian controlled private corporation. Based on the formula in ITR 402(3), 90 percent of the Company's income is earned in a province. The following information is available for the year ending December 31, 2019:

| | |
|---|---|
| Canadian Source Investment Income | |
| (Includes $25,000 In Taxable Capital Gains) | $100,000 |
| Gross Foreign Non-Business Income (15 Percent Withheld) | 20,000 |
| Gross Foreign Business Income (15 Percent Withheld) | 10,000 |
| Active Business Income (No Associated Companies) | 150,000 |
| Portfolio Dividends Received | 30,000 |
| Net Income For Tax Purposes | $310,000 |
| Portfolio Dividends | ( 30,000) |
| Net Capital Loss Carry Forward Deducted | ( 15,000) |
| Taxable Income | $265,000 |

| | |
|---|---|
| RDTOH - December 31, 2018 | $30,000 |
| Dividend Refund For 2018 | 7,000 |
| Taxable Dividends Paid During 2019 | 60,000 |
| GRIP - December 31, 2018 | 20,000 |
| Eligible Dividends Designated in 2018 | 8,000 |
| 2018 Taxable Capital Employed in Canada (TCEC) | 2,400,000 |
| 2018 ADJUSTED Aggregate Investment Income | 32,000 |

**ANALYSIS** Reflecting the fact that the 2018 TCEC was less than $10 million and the 2018 ADJUSTED Aggregate Investment Income was less than $50,000, there would be no grind of the annual business limit for the small business deduction.

After subtracting the dividend refund for 2018, the opening RDTOH balance would be $23,000 ($30,000 - $7,000). The transitional rules must be applied to this balance in order to divide it between eligible and non-eligible amounts.

The January 1, 2019 GRIP balance is $12,000 ($20,000 - $8,000).

Based on this, the transitional Eligible RDTOH would be $4,600, the lesser of:

- The Opening RDTOH Balance = $23,000
- [(38-1/3%)(Opening GRIP Balance)] = [(38-1/3%)($12,000)] = $4,600

This calculation would leave $18,400 ($23,000 - $4,600) for the transitional Non-Eligible RDTOH balance.

The Part I Tax Payable would be calculated as follows:

| | |
|---|---|
| Base Amount Of Part I Tax [(38%)($265,000)] | $100,700 |
| Federal Tax Abatement [(10%)(90%)($265,000)] | ( 23,850) |
| Small Business Deduction (Note 1) | ( 28,500) |
| ART (Note 2) | 11,200 |
| General Rate Reduction (Note 3) | ( 1,300) |
| Foreign Non-Business Tax Credit (Note 1) | ( 3,000) |
| Foreign Business Tax Credit (Note 1) | ( 1,500) |
| Part I Tax Payable | $ 53,750 |

**Note 1** In order to simplify the calculation of the small business deduction, the foreign tax credits are assumed to be equal to the amounts withheld (15 percent). Additional calculations would be required to support this conclusion.

The small business deduction would be equal to 19 percent of the least of:

| | |
|---|---|
| 1. Active Business Income | $150,000 |
| 2. Taxable Income | $265,000 |
| Deduct: | |
| [(100/28)($3,000 Foreign Non-Business Tax Credit)] | ( 10,714) |
| [(4)($1,500 Foreign Business Tax Credit)] | ( 6,000) |
| Adjusted Taxable Income | $248,286 |
| 3. Annual Business Limit | $500,000 |

The small business deduction is $28,500 [(19%)($150,000)].

**Note 2** The Additional Refundable Tax (ART) is equal to 10-2/3 percent of the lesser of:

- Aggregate Investment Income, calculated as follows:

| | |
|---|---|
| Canadian Source Investment Income | $100,000 |
| Gross Foreign Non-Business Income | 20,000 |
| Net Capital Loss Carry Forward Deducted | ( 15,000) |
| Aggregate Investment Income | $105,000 |

- An amount calculated as follows:

| | |
|---|---|
| Taxable Income | $265,000 |
| Amount Eligible For the Small Business Deduction | ( 150,000) |
| Balance | $115,000 |

This results in an ART equal to $11,200 [(10-2/3%)($105,000)].

**Note 3** The general rate reduction would be calculated as follows:

| | |
|---|---|
| Taxable Income | $265,000 |
| Amount Eligible For Small Business Deduction (Note 1) | ( 150,000) |
| Aggregate Investment Income | ( 105,000) |
| Full Rate Taxable Income (= Foreign Business Income) | $ 10,000 |
| Rate | 13% |
| General Rate Reduction | $ 1,300 |

13-164. Based on the preceding information, the refundable portion of Part I tax would be the least of the following three amounts:

| | | |
|---|---|---|
| 30-2/3% Of Aggregate Investment Income [(30-2/3%)($105,000)] | | $ 32,200 |
| Deduct Excess Of: | | |
| Foreign Non-Business Tax Credit | ($3,000) | |
| Over 8% Of Foreign Investment Income [(8%)($20,000)] | 1,600 | ( 1,400) |
| **Amount Under ITA 129(4)(a)(i)** | | **$ 30,800** |
| Taxable Income | | $265,000 |
| Deduct: | | |
| Amount Eligible For Small Business Deduction | ($150,000) | |
| [(100 ÷ 38-2/3)($3,000 Foreign Non-Business Tax Credit)] | ( 7,759) | |
| [(4)($1,500 Foreign Business Tax Credit)] | ( 6,000) | ( 163,759) |
| Total | | $101,241 |
| Rate | | 30-2/3% |
| **Amount Under ITA 129(4)(a)(ii)** | | **$ 31,047** |
| **Amount Under ITA 129(4)(a)(iii)** = Part I Tax Payable | | **$ 53,750** |

The refundable portion of Part I tax is equal to $30,800, which is the least of the preceding three amounts.

13-165. The Part IV tax would be $11,500, 38-1/3 percent of the $30,000 in portfolio dividends received.

13-166. The ending balance in the Eligible RDTOH would be calculated as follows:

| | |
|---|---|
| Transitional Balance | $ 4,600 |
| Part IV Tax On Portfolio Dividends | 11,500 |
| December 31, 2019 Eligible RDTOH | $16,100 |

13-167. The ending balance in the Non-Eligible RDTOH would be calculated as follows:

| | |
|---|---|
| Transitional Balance | $18,400 |
| Part I Refundable Tax | 30,800 |
| December 31, 2019 Non-Eligible RDTOH | $49,200 |

13-168. The ending GRIP balance would be calculated as follows:

| | |
|---|---|
| Opening Balance | $12,000 |
| Portfolio Dividends Received | 30,000 |
| December 31, 2019 GRIP Balance | $42,000 |

13-169. Of the total dividends paid of $60,000, the amount that can be designated as eligible is limited to the GRIP balance of $42,000. The refund on these dividends is the lesser of:

- $16,100 [(38-1/3%)($42,000)]; and
- $16,100, the ending balance in the Eligible RDTOH.

13-170. If the maximum designation is made, $42,000 would be subtracted from the ending 2019 GRIP in 2020. Similarly, the $16,100 refund would be subtracted from the ending 2019 Eligible RDTOH in 2020.

13-171. With $42,000 of the dividends designated as eligible, the remaining $18,000 ($60,000 - $42,000) will be non-eligible. On these dividends, the refund will be the lesser of:

- $6,900 [(38-1/3%)($18,000)]; and
- $49,200, the ending balance in the Non-Eligible RDTOH.

13-172. The $6,900 would be subtracted from the ending 2019 Non-Eligible RDTOH in 2020.

13-173. The total refund is $23,000 ($16,100 + $4,900). Note that this is equal to 38-1/3 percent of the $60,000 in total dividends paid.

13-174. Given the receding calculations, Fortune's total federal Tax Payable is as follows:

| | |
|---|---|
| Part I Tax Payable | $53,750 |
| Part IV Tax Payable | 11,500 |
| Dividend Refund | ( 23,000) |
| Federal Tax Payable | $42,250 |

## Working Through Large Corporate Tax Problems

13-175. At this point we have completed our general coverage of Taxable Income and Tax Payable for corporations. As we are sure you are aware, there are a great many concepts and procedures involved in this process. While we have illustrated the concepts and procedures in individual examples, we have not provided a comprehensive example that encompasses all of these items.

13-176. You will find, however, that several of the Self Study and Assignment Problems involve fairly comprehensive calculations of corporate Taxable Income and Tax Payable. Given the complexity of these problems, it is useful to have a systematic approach to dealing with this type of problem. To fill that need, we would suggest you approach the required calculations in the following order (we are assuming that only federal taxes are being calculated as this is generally the case with the problem material in this text):

- Net Income For Tax Purposes. Depending on the problem, this may require converting an accounting Net Income figure into the required tax figure.
- Taxable Income. This would include making deductions for charitable donations, dividends from taxable Canadian corporations, and loss carry overs.
- Basic federal Part I Tax Payable at the 38 percent rate.
- Federal tax abatement. If there is foreign business income, this may require a calculation of the amounts that are to be allocated to Canadian provinces.
- If the corporation is a CCPC:
    - Determine Taxable Capital Employed in Canada (TCEC) and ADJUSTED Aggregate Investment Income **for the previous year**.
    - Small business deduction (without consideration of the general rate reduction or the ART in the foreign income tax credit constraints).
    - Aggregate investment income.
    - Additional refundable tax on investment income (ART). Note that this is an addition to Part I Tax Payable, not a deduction.
- Manufacturing and processing profits deduction (without consideration of the general rate reduction in the foreign income tax credit constraints).
- General rate reduction.
- Foreign non-business income tax credit.
- Foreign business income tax credit.
- If the corporation is a CCPC:
    - Refundable portion of Part I tax.
    - the GRIP balance.

- If the corporation is a CCPC or other private corporation:
  - Part IV tax payable.
  - Balance in the Eligible and Non-Eligible refundable dividend tax on hand accounts.
  - Dividend refund on eligible dividends and non-eligible dividends.

**We suggest you work Self Study Problems Thirteen-6, 7, 8, and 9 at this point.**

**Additional Supplementary Self Study Problems Are Available Online.**

# Key Terms Used In This Chapter

13-177. The following is a list of the key terms used in this Chapter. These terms, and their meanings, are compiled in the Glossary located at the back of the Study Guide.

Additional Refundable Tax On Investment Income (ART)
ADJUSTED Aggregate Investment Income
Aggregate Investment Income
ART
Canadian Controlled Private Corporation
CCPC
Connected Corporation
Dividend Gross Up
Dividend Tax Credit
Dividends
Eligible Dividends
Eligible RDTOH
Excessive Eligible Dividend Designation (EEDD)
General Rate Income Pool (GRIP)
Integration
Low Rate Income Pool (LRIP)
Non-Eligible RDTOH
Over Integration
Part IV Tax
Portfolio Dividend
Private Corporation
Public Corporation
RDTOH
Refundable Dividend Tax On Hand
Refundable Part I Tax
Subject Corporation
Under Integration

# References

13-178. For more detailed study of the material in this Chapter, we refer you to the following:

| | |
|---|---|
| ITA 82(1) | Taxable Dividends Received |
| ITA 89(1) | Definitions (Canadian Corporations, GRIP, LRIP, and EEDD) |
| ITA 123.3 | Refundable Tax On CCPC's Investment Income |
| ITA 123.4 | General Rate Reduction |
| ITA 129(1) | Dividend Refund To Private Corporation |
| ITA 129(4) | Definition Of Eligible And Non-Eligible Refundable Dividend Tax On Hand |
| ITA 129(4) | Aggregate Investment Income |
| ITA 129(5) | 2019 Transitional RDTOH |
| ITA 185.1 | Tax On Excessive Eligible Dividend Designations |
| ITA 185.2 | Election To Treat Excessive Eligible Dividend As An Ordinary Dividend |
| ITA 186 | Part IV Tax |
| IT-67R3 | Taxable Dividends From Corporations Resident In Canada |
| IT-243R4 | Dividend Refund To Private Corporations |
| IT-269R4 | Part IV Tax On Taxable Dividends Received By a Private Corporation Or A Subject Corporation |
| IT-391R | Status Of Corporations |
| IT-458R2 | Canadian Controlled Private Corporation |

## Sample Corporate Tax Return For Chapter 13

The Sample Tax Return for this Chapter can be found in the print and online Study Guide.

## Problems For Self Study (Online)

To provide practice in problem solving, there are Self Study and Supplementary Self Study problems available on MyLab Accounting.

Within the text we have provided an indication of when it would be appropriate to work each Self Study problem. The detailed solutions for Self Study problems can be found in the print and online Study Guide.

We provide the Supplementary Self Study problems for those who would like additional practice in problem solving. The detailed solutions for the Supplementary Self Study problems are available online, not in the Study Guide.

The .PDF file "Self Study Problems for Volume 2" on MyLab contains the following for Chapter 13:

- 9 Self Study problems,
- 4 Supplementary Self Study problems, and
- detailed solutions for the Supplementary Self Study problems.

## Assignment Problems

(The solutions for these problems are only available in the solutions manual that has been provided to your instructor.)

### *Assignment Problem Thirteen - 1*

***(Integration Example)***

Assume the following with respect to the shareholder of a CCPC who is an individual.

- The corporation's business income for the year is $225,000.
- Any dividends paid are non-eligible dividends.
- The individual's marginal federal tax rate is 29 percent and his marginal provincial tax rate is 16 percent.
- The provincial dividend tax credit on non-eligible dividends is equal to 35 percent of the gross up.
- The combined federal and provincial corporate tax rate on business income is 13.0435 percent.

**Required**: Indicate, using these assumptions, whether integration is working perfectly. If your answer is no, briefly explain why this is the case.

### Assignment Problem Thirteen - 2

#### (Part I and Part IV Refundable Taxes)

Burton Investments Ltd. is a Canadian controlled private corporation that sells office supplies. It owns 52 percent of the outstanding shares of Puligny Inc. On December 15, 2019, Puligny Inc. declared and paid a dividend of $122,000, of which Burton Investments Ltd. received $63,440 (52 percent). None of this dividend was designated as eligible by Puligny. As a result of paying the $122,000 dividend, Puligny Inc. received a dividend refund in the amount of $12,500.

Other 2019 income that was reported by Burton Investments consisted of the following amounts:

| | |
|---|---|
| Capital Gain | $18,000 |
| Eligible Dividends From Bank Of Montreal Shares | 13,480 |
| Interest | 1,150 |

The capital gain was on the sale of land that had been used as an auxiliary parking lot, but was no longer needed.

Burton's office supply business is seasonal and, as a consequence, temporary cash balances must be set aside for the purchase of inventories during the busy parts of the year. All of the $1,150 in interest was earned on such temporary cash balances.

At the end of 2018, the Company's Refundable Dividend Tax On Hand balance was $22,346. The 2018 dividend refund was $7,920. The corporation did not have a GRIP balance on December 31, 2018.

The Company's Taxable Income for the year ending December 31, 2019 was $62,800. No foreign income was included in this total. Assume the Part I Tax Payable for the year ending December 31, 2019 was correctly calculated as $12,560. Because of its association with Puligny Inc., its share of the annual business limit on income eligible for the small business deduction is $40,000. Burton's active business income is more than its share of the annual business limit.

Burton Investments paid taxable dividends of $22,500 in 2019. It is the policy of the corporation to designate dividends as eligible only to the extent that a dividend refund will be available on their payment.

For 2018, Burton and Puligny had combined ADJUSTED Aggregate Investment Income of $23,000. Their combined Taxable Capital Employed In Canada was $1,600,000 for 2018.

**Required:**

A. Determine the transitional balances for Burton's Eligible RDTOH and its Non-Eligible RDTOH.

B. Determine the refundable portion of Burton's Part I Tax Payable for 2019.

C. Determine Burton's Part IV Tax Payable for 2019.

D. Determine the December 31, 2019 balances in Burton's Eligible RDTOH and its Non-Eligible RDTOH.

E. Determine Burton's 2019 dividend refund, providing separate amounts for refunds on eligible dividends and refunds on non-eligible dividends.

### Assignment Problem Thirteen - 3

#### (Transitional RDTOH Balances)

Matco Ltd. is a CCPC that uses December 31 as its taxation year end. On December 31, 2018, the corporation had an RDTOH balance of $57,500. Its dividend refund for 2018 was $7,667. Determine the January 1, 2019 transitional amounts for the Eligible RDTOH and the Non-Eligible RDTOH based on the information in each of the following independent cases.

**Case 1** On December 31, 2018, Matco has no GRIP balance.

**Case 2** On December 31, 2018, Matco has a GRIP balance of $175,000. During 2018, the corporation designated $150,000 of dividends paid as eligible.

**Case 3** On December 31, 2018, Matco has a GRIP balance of $390,000. During 2018, the corporation designated $120,000 of dividends paid as eligible.

## Assignment Problem Thirteen - 4

### (Dividend Refund)

#### Case 1

Ho Trading Company is a Canadian controlled private corporation with a December 31 year end. On December 31, 2019, it had the following balances in its accounts:

| | |
|---|---|
| GRIP | $150,000 |
| Eligible RDTOH | 38,333 |
| Non-Eligible RDTOH | 76,667 |

During the year, the corporation paid taxable dividends of $250,000. The corporation would like to maximize the amount of this dividend that is designated as eligible.

Determine the amounts for the corporation's 2019 dividend refund on eligible dividends paid and the corporation's 2019 dividend refund on non-eligible dividends paid.

#### Case 2

Amadeus Ltd. is a Canadian controlled private corporation with a December 31 year end. On December 31, 2019, it had the following balances in its accounts:

| | |
|---|---|
| GRIP | $400,000 |
| Eligible RDTOH | 95,833 |
| Non-Eligible RDTOH | 134,167 |

During the year, the corporation paid taxable dividends of $500,000. It is the policy of the corporation to designate dividends as eligible, only to the extent that a refund is available.

Determine the amounts for the corporation's 2019 dividend refund on eligible dividends paid and the corporation's 2019 dividend refund on non-eligible dividends paid.

## Assignment Problem Thirteen - 5

### (Part I And Part IV Refundable Taxes, GRIP)

Radco Inc. is a Canadian controlled private corporation with a December 31 year end. The various components of its Net Income For Tax Purposes are as follows:

| | |
|---|---|
| • Active Business Income (Note 1) | $823,462 |
| • Taxable Capital Gains | 161,576 |
| • Canadian Source Interest From Long-Term Investments | 71,345 |
| • Dividends (Note 2) | 614,292 |

**Note 1** As determined under ITR 5200, $624,560 of this total qualified as M&P profits. As these amounts are allocated to a province which has a special rate for M&P profits, the company calculates the federal M&P deduction.

**Note 2** The total dividend figure is made up of the following amounts:

| | |
|---|---|
| Eligible Dividends From Canadian Public Companies | $123,470 |
| Non-Eligible Dividends From Nad Ltd. (Note 3) | 279,217 |
| Non-Eligible Dividends From Jad Ltd. (Note 3) | 211,605 |
| Total Dividends | $614,292 |

**Note 3** Radco owns 100 percent of the shares of Nad Ltd. As a result of paying this dividend, Nad Ltd. received a dividend refund of $57,236 from its non-eligible RDTOH. Radco owns 40 percent of Jad Ltd. Jad Ltd. did not receive a dividend refund as a result of paying these dividends.

**Additional Information**

1. On September 12, 2019, Radco paid taxable dividends to its shareholders totaling $186,780. It is the policy of the company to designate dividends as eligible only to the extent that their payment will result in a dividend refund.
2. At the beginning of 2019, Radco has a net capital loss carry forward $172,400 [(1/2)($344,800)]. In addition, there is a non-capital loss carry forward of $18,263. The Company would like to deduct as much as possible of these carry forwards during 2019.
3. Radco is associated with both Nad Ltd. and Jad Ltd. The Companies have agreed that Nad and Jad will each receive $150,000 of the small business deduction's annual business limit. The remaining $200,000 is allocated to Radco.
4. For 2018, Radco and its associated companies had combined ADJUSTED Aggregate Investment Income of $41,600. Their Taxable Capital Employed In Canada totaled $8,672,000 for 2018.
5. At December 31, 2018, Radco had a RDTOH balance of $19,742 and a GRIP balance of $32,476. During 2018, the Company paid taxable dividends of $30,000, $12,000 of which were designated as eligible. As a result of paying the dividends, Radco received a dividend refund of $11,500 [(38-1/%)($30,000)].
6. Using the formula found in ITR402(3), 90 percent of Radco's Taxable Income has been allocated to the provinces.

**Required:** Show all of the calculations used to provide the following required information, including those for which the result is nil.

For Radco Inc.'s 2019 taxation year, calculate the following items:

A. Part I Tax Payable.
B. The refundable portion of Part I Tax Payable.
C. Part IV Tax Payable.
D. The balance in the GRIP account on December 31, 2019.
E. The balance in the Eligible RDTOH and the balance in the Non-Eligible RDTOH on December 31, 2019.
F. The dividend refund, if any, showing separately the amount related to eligible dividends and the amount related to non-eligible dividends.
G. Total federal Tax Payable (net of any dividend refund).

## *Assignment Problem Thirteen - 6*

### *(Comprehensive Corporate Tax Payable With CCA)*

Oland Ltd. is a Canadian controlled private corporation with a December 31 year end. For the year ending December 31, 2019, the Income Statement of the Company, prepared in accordance with generally accepted accounting principles, is as follows:

| | | |
|---|---|---|
| Revenues | | $1,625,986 |
| Expenses: | | |
| Cost Of Goods Sold | ($776,257) | |
| Selling And Administrative Costs | ( 394,672) | |
| Amortization Expense | ( 125,489) | |
| Charitable Donations | ( 27,000) | ( 1,323,418) |
| Operating Income | | $ 302,568 |
| Gain On Sale Of Property | $153,600 | |
| Loss On Sale Of Vehicles | ( 55,000) | |
| Gain On Sale Of Investments | 11,000 | |
| Dividends Received (See Note) | 123,400 | 233,000 |
| Net Income Before Taxes | | $ 535,568 |

**Note** The components of the dividends received are as follows:

| | |
|---|---|
| Eligible Dividends From Canadian Public Companies | $ 62,300 |
| Non-Eligible Dividends From 80 Percent Owned Subsidiary (The Subsidiary Received A Dividend Refund Of $15,000 From Its Non-Eligible RDTOH) | 48,000 |
| Non-Eligible Dividends From Wholly Owned Subsidiary (No Dividend Refund) | 13,100 |
| Total Dividends Received | $123,400 |

Oland is associated with both of these companies. The two subsidiaries have each been allocated $125,000 of the small business deduction's annual business limit. The remaining $250,000 has been allocated to Oland.

**Other Information:**

1. Selling And Administrative Costs include $22,490 in business meals and entertainment.
2. Selling And Administrative Costs includes interest on late income tax instalments of $1,240 and on late municipal tax payments of $625.
3. Selling And Administrative Costs includes bond discount amortization of $3,850.
4. During 2019, Oland Ltd. acquired a competing business at a price that included goodwill of $110,400. For accounting purposes, there is no impairment or write-down of the goodwill in 2019.
5. Selling And Administrative Costs include membership fees for several employees in a local golf and country club. These fees total $7,285.
6. As the Company expects to issue more shares during 2019, it made a number of amendments to its articles of incorporation and included the legal costs in Selling And Administrative Costs. These costs totalled $11,482.
7. On January 1, 2019, the Company had the following UCC balances:

| | |
|---|---|
| Class 1 | $582,652 |
| Class 8 | 575,267 |
| Class 10 | 75,348 |
| Class 13 | 88,600 |
| Class 14.1 | Nil |

The Class 1 balance relates to a single real property acquired in 2000 at a cost of $750,000. It is estimated that the value of the land at this time was $50,000. On February 1, 2019, this property is sold for $850,000. It is estimated that, at this time, the value of the land has increased to $80,000. In the accounting records, this real property was carried at $696,400, $646,400 for the building and $50,000 for the land.

The old building is replaced on February 15, 2019 with a new building acquired at a cost of $923,000 of which $86,000 is allocated to land. As the building is used more than 90 percent for non-residential purposes, it qualifies for the special 6 percent CCA rate. In order to use this rate, the building is put into a separate CCA class. No elections are made with respect to the replacement of the building.

During 2019, Class 8 assets were acquired at a cost of $226,000. Class 8 assets with a capital cost of $185,000 were sold for $210,000. These Class 8 assets were paintings by Canadian artists and each was sold for an amount in excess of its cost. The accountant had not amortized them for accounting purposes as he could not determine an estimated useful life. Class 8 contains a large number of assets at the end of 2019.

As the Company has decided to lease all of its vehicles in the future, all of the assets in Class 10 are sold during the year. The capital cost of these assets was $142,000 and the proceeds of disposition amounted to $43,000. The net book value of these assets was $98,000.

The Class 13 balance relates to a single lease that commenced on January 1, 2014. The lease has an initial term of seven years, with two successive options to renew for three years each. At the inception of the lease, the Company spent $110,000 on leasehold improvements. On January 1, 2016, an additional $44,800 was spent on further improvements.

8. It is Oland's policy to deduct maximum amounts of CCA.
9. During 2019, Oland spends $18,500 landscaping the grounds of its new building. For accounting purposes this was treated as an asset. However, the Company will not amortize this balance as it believes the work has an unlimited life.
10. Investments were sold during the year for $126,000. The adjusted cost base of these investments was $115,000.
11. On December 31, 2018, the Company had a balance in its Refundable Dividend Tax On Hand account of $52,460. The Company claimed a dividend refund of $12,800 in its 2018 corporate tax return.
12. At the end of 2018, Oland has a GRIP balance of $162,345. During 2018, the Company designated $12,350 of its dividends paid as eligible.
13. During 2019, Oland paid $42,300 in dividends. Of this total, $26,300 were designated as eligible.
14. At the beginning of 2019, Oland had a $23,000 net capital loss carry forward [(1/2)($46,000)]. It also had a non-capital loss carry forward of $36,400. The Company would like to deduct as much as possible of these two carry overs during 2019.
15. All of Oland's Taxable Income will be allocated to a province.
16. It has been determined that Oland has $300,289 of active business income. Of this total, $43,000 results from manufacturing and processing activity. Because of special rates in the province in which it operates, Oland makes a separate calculation of the manufacturing and processing deduction.
17. For 2018, Oland and its associated companies had combined ADJUSTED Aggregate Investment Income of $48,900. Their Taxable Capital Employed In Canada totalled $8,900,000 for 2018.

**Required**: Show all of the calculations used to provide the following required information, including those for which the result is nil.

A. Determine Oland's minimum Net Income For Tax Purposes and Taxable Income for the year ending December 31, 2019. Include in your solution the January 1, 2020 UCC balance for each CCA class.

B. Determine Oland's Part I Tax Payable for the year ending December 31, 2019.

C. Determine the refundable portion of Oland's Part I Tax Payable for 2019.

D. Determine Oland's Part IV Tax Payable for the 2019.

E. Determine the December 31, 2019 balance in Oland's GRIP.

F. Determine the December 31, 2019 balances in Oland's Eligible RDTOH and Non-Eligible RDTOH.

G. Determine Oland's dividend refund for 2019, separately identifying the refund related to eligible dividends and the refund related to non-eligible dividends.

H. Determine Oland's net federal Tax Payable for 2019.

### *Assignment Problem Thirteen - 7*

***(Comprehensive Corporate Tax Payable)***

Fancom Inc. is an Alberta corporation that qualifies as a Canadian controlled private company. For the taxation year ending December 31, 2019, the components of its Net Income For Tax Purposes and Taxable Income are as follows:

| | |
|---|---:|
| Active Business Income (Note 1) | $328,000 |
| Gross Foreign Business Income (Note 2) | 40,800 |
| Gross Foreign Non-Business Income (Note 2) | 31,200 |
| Interest On Long-Term Investments | 49,900 |
| Taxable Capital Gains (Note 3) | 16,500 |
| Eligible Dividends Received On Portfolio Investment | 21,000 |
| **Net Income For Tax Purposes** | **$487,400** |
| Eligible Dividends Received | ( 21,000) |
| Charitable Contributions | ( 86,400) |
| Net Capital Loss Carry Forward Deducted | ( 13,900) |
| Non-Capital Loss Carry Forward Deducted | ( 263,000) |
| **Taxable Income** | **$103,100** |

**Note 1** As determined by the *Income Tax Regulations*, $152,000 of this active business income was manufacturing and processing profits. As these amounts are allocated to a province which has a special rate for M&P profits, the company calculates the federal M&P deduction.

**Note 2** Foreign jurisdictions withheld $6,120 (15%) from the foreign business income and $7,800 (25%) from the foreign non-business income.

**Note 3** The $6,500 is one-half of a capital gain of $33,000. The gain resulted from a disposition of passive investments.

**Other Information:**

1. During the year ending December 31, 2019, Fancom used its existing cash resources to pay taxable dividends of $223,200. Of this total, $49,300 were designated as eligible.
2. As of December 31, 2018, Fancom Inc. has a GRIP of $49,360. During 2018, the Company designated $8,700 of its dividends paid as eligible.
3. As of December 31, 2018, the balance in Fancom's RDTOH account was $27,400. A dividend refund of $13,400 was claimed in the 2018 corporate tax return.
4. For 2018, Fancom's ADJUSTED Aggregate Investment Income was $36,450. Its Taxable Capital Employed In Canada was $4,652,300 for 2018.

5. As determined by the *Income Tax Regulations*, 85 percent of Fancom's Taxable Income can be allocated to a Canadian province.
6. Assume that the foreign business and non-business tax credits are equal to the foreign taxes withheld.

**Required:** Show all of the calculations used to provide the following required information, including those for which the result is nil.

A. Determine Fancom's Part I Tax Payable for the year ending December 31, 2019.

B. Determine the refundable portion of Fancom's Part I Tax Payable for 2019.

C. Determine Fancom's Part IV Tax Payable for the 2019.

D. Determine the December 31, 2019 balance in Fancom's GRIP.

E. Determine the December 31, 2019 balances in Fancom's Eligible RDTOH and Non-Eligible RDTOH.

F. Determine Fancom's dividend refund for 2019, separately identifying the refund related to eligible dividends and the refund related to non-eligible dividends.

## Assignment Problem Thirteen - 8

### (Comprehensive Corporate Tax Payable)

Ferris Ltd. is a Canadian controlled private corporation. For the year ending December 31, 2019, its accounting Net Income Before Taxes, as determined under generally accepted accounting principles, was $600,600. Other information for the 2019 fiscal year follows.

1. The Company's amortization expense was $711,200. Maximum deductible CCA for the year was $946,000. It is the Company's policy to always deduct maximum available CCA.
2. The Company's revenues included foreign source non-business income of $22,100 (Canadian dollars). This was the amount that was received after the withholding of $3,900 (15 percent of the gross amount) by the foreign tax authorities.
3. Ferris sold depreciable assets for $582,000. These assets had an original cost of $510,000 and a net book value of $435,000. They were Class 8 assets and, at the beginning of 2019, the UCC balance in this class was $442,000. No Class 8 assets were purchased during the year. The Company has numerous assets left in this class at the end of the year.
4. During the year, the Company had the following amounts of Canadian source investment income:

| | |
|---|---|
| Interest On Long-Term Investments | $31,600 |
| Taxable Capital Gains On Sale Of Depreciable Assets | 36,000 |
| Eligible Dividends On Bank of Nova Scotia Shares | 14,200 |

5. During the year, the Company begins selling a product on which they provide a 10 year warranty. At the end of the year, they established a warranty reserve of $25,000 to reflect the expected costs of providing warranty services. No costs were incurred in 2019.
6. The Company spent $66,400 on business meals and entertainment.
7. It has been determined that Ferris has active business income of $277,100 for the year. Included in this amount were manufacturing and processing profits, as determined by the *Income Tax Regulations*, of $188,300.
8. During the year ending December 31, 2019, the Company used its existing cash resources to pay taxable dividends of $274,000. It is the policy of the corporation to only designate dividends as eligible to the extent that they will have a refund available.

9. As of December 31, 2018, Ferris Ltd. has a GRIP of $26,500. During 2018, the Company designated all of the $8,100 in taxable dividends paid as eligible.
10. As of December 31, 2018, the balance in Ferris's RDTOH account was $21,700. A dividend refund of $2,700 was claimed in the 2018 corporate tax return.
11. The Company has available a non-capital loss carry forward of $267,300 and a net capital loss carry forward of $24,800 [(1/2)($49,600)]. Management has indicated that they would like to deduct as much of these amounts as possible in the 2019 tax return.
12. For 2018, Ferris had ADJUSTED Aggregate Investment Income of $41,300. Its Taxable Capital Employed In Canada was $3,641,000.

**Required:** Show all of the calculations used to provide the following required information, including those for which the result is nil.

A. Calculate Ferris's minimum Net Income For Tax Purposes and Taxable Income for the year ending December 31, 2019.

B. Assume the foreign non-business tax credit is equal to the foreign tax withheld. Calculate Ferris's Part I Tax Payable for the year ending December 31, 2019. As the corporation operates in a province that has a reduced rate for M&P activity, a separate calculation of the federal M&P deduction is required.

C. Calculate the refundable portion of Ferris's Part I Tax Payable for 2019

D. Calculate Ferris's Part IV Tax Payable for the year ending December 31, 2019.

E. Determine the December 31, 2019 balance in Ferris's GRIP account.

F. Determine the December 31, 2019 balances in the Eligible RDTOH and the Non-Eligible RDTOH.

G. Calculate Ferris's dividend refund for the year ending December 31, 2019.

H. Do not assume the foreign non-business tax credit is equal to the foreign tax withheld, but assume that any excess of foreign tax withheld over the federal foreign tax credit will be applied against the provincial tax liability. Using the amounts calculated in Part B, compare your results under this new scenario with the Part B calculation of Part I Tax Payable. As part of your solution, provide a detailed calculation of the small business deduction, the ITA 123.3 refundable tax (ART) and the foreign tax credit available to Ferris for the year ending December 31, 2019.

I. Assume that any excess of foreign tax withheld over the federal foreign tax credit cannot be applied against the provincial tax liability. Comment on any tax planning issues that should be reviewed because of this change in assumption.

### Assignment Problem Thirteen - 9

#### (Comprehensive Tax Payable)

Industco Inc. is a Canadian controlled private corporation. It uses a taxation year that ends on December 31. It keeps its records in accordance with generally accepted accounting principles. For the year ending December 31, 2019, the Company's condensed Income Statement, is as follows:

| | | |
|---|---|---|
| Operating Revenues In Canada | | $2,937,500 |
| Operating Expenses In Canada | | ( 1,905,000) |
| Operating Income In Canada | | $1,032,500 |
| Other Income Items: | | |
| Eligible Portfolio Dividends | $ 52,000 | |
| Foreign Non-Business Income (Net Of 15 Percent Withholding) | 25,500 | |
| Foreign Business Income (Net Of 10 Percent Withholding) | 45,000 | |
| Canadian Source Interest | 26,000 | |
| Gain On Sale Of Class 8 Assets | 225,000 | 373,500 |
| Accounting Income Before Taxes | | $1,406,000 |

Other information related to operating expenses follows.

**Amortization And CCA** The operating income figure was reduced by a charge for amortization of $623,000.

At the beginning of 2019, the Company has a balance in Class 1 of $1,000,000. The only asset in the Class is the Company's headquarters building. The Company has owned this building since 2001.

In general, other property is leased. However, in February, 2019, a policy change results in the acquisition of a new building at a cost of $650,000, of which $125,000 is allocated to the land on which the building is situated. The building is used 100 percent for non-residential purposes and is allocated to a separate Class 1. One-half of the non-residential use is for manufacturing and processing.

The January 1, 2019 balance in Class 8 was $4,200,000. During 2019, there were additions to this class in the total amount of $700,000. Also, Class 8 assets with a cost of $400,000 were sold for proceeds of $550,000. The net book value of these assets in the accounting records was $325,000. There were numerous assets remaining in the class at the end of the 2019 taxation year.

At the beginning of 2019, the UCC in Class 10 was $800,000, reflecting the Company's fleet of trucks. As the Company is changing to a policy of leasing its trucks, all of these trucks were sold during the year for $687,000. The capital cost of the trucks was $1,200,000 and their net book value in the accounting records was equal to the sale proceeds of $687,000.

**Landscaping** The Company spent $95,000 on landscaping for its main office building. This amount was recorded as an asset in the accounting records and, because the work has an unlimited life, no amortization was recorded on this asset.

**Advertising** The Company spent $17,000 on advertisements in *Fortune* Magazine, a U.S. based publication. Over 90 percent of the magazine's non-advertising content is original editorial content. The advertisements were designed to promote sales in Canadian cities located on the U.S. border.

**Travel And Entertainment** Included in the travel costs deducted in 2019 was $12,000 for airline tickets and $41,400 for business meals and entertainment.

The Company paid, and deducted for accounting purposes, a $2,500 initiation fee for a corporate membership in the Highland Golf And Country Club.

**Taxes On Vacant Land** The Company paid, and deducted, property taxes of $15,000 on vacant land that is being held for possible future expansion of its headquarters site.

**Other Information**

1. Industco Inc. declared and paid taxable dividends of $83,000 during 2019. It is the policy of the corporation to only designate dividends as eligible to the extent that their payment will result in a dividend refund.
2. It has been determined that 92 percent of Industco's Taxable Income can be allocated to a province.
3. The December 31, 2018 balance in Industco's Refundable Dividend Tax On Hand account was $111,000. The dividend refund for the year ending December 31, 2018 was $33,000.
4. At the end of 2018, Industco Inc. has a GRIP balance of $298,000. During 2018, the company designated $64,000 of its dividends paid as eligible.
5. Industco Inc. is associated with two other Canadian controlled private corporations. Industco has been allocated $125,000 of the annual business limit.
6. Assume that the foreign tax credits for the foreign non-business and foreign business income are equal to the amounts withheld.
7. Industco's Canadian active business income is equal to its net business income for tax purposes. One-half of this Canadian active business income results from manufacturing and processing activity.
8. At the beginning of 2019, Industco has a net capital loss carry forward of $42,000 and a non-capital loss carry forward $18,000. The Company intends to deduct the maximum amount of these carry forwards during 2019.
9. For 2018, the ADJUSTED Aggregate Investment Income of Industco and its associated companies is $31,600. Their Taxable Capital Employed In Canada was $6,420,000.

**Required:** Determine the following amounts. You should show all of the calculations required to provide these amounts, even when the result of the calculations is nil.

A. Industco's Net Income For Tax Purposes and Taxable Income for the year ending December 31, 2019. As the Company's active business income is based on its net business income for tax purposes, a separate calculation of this component of Net Income For Tax Purposes is required.

B. Industco's Part I Tax Payable for the year ending December 31, 2019. As the corporation operates in a province that has a reduced tax rate for manufacturing and processing activity, a separate calculation of the federal M&P deduction is required.

C. The refundable portion of Industco's Part I Tax Payable for 2019.

D. Industco's Part IV Tax Payable for 2019.

E. Industco's GRIP balance on December 31, 2019.

F. The balances in Industco's Eligible RDTOH and Non-Eligible RDTOH on Decembert 31, 2019.

G. Industco's dividend refund for 2019, showing separately the amount related to eligible dividends and the amount related to non-eligible dividends.

# CHAPTER 14

# Other Issues In Corporate Taxation

## Introduction

14-1. Chapters 12 and 13 dealt with basic issues associated with the determination of Taxable Income and Tax Payable for a corporation. Specifically, Chapter 12 described the basic adjustments associated with converting Net Income For Tax Purposes to corporate Taxable Income. This was followed by consideration of how this Taxable Income is allocated to specific provinces for the determination of provincial Tax Payable. With respect to Tax Payable, Chapter 12 dealt with the rates applicable to corporations, the small business deduction, the M&P deduction, foreign tax credits, and the general rate reduction. Included is material on the annual business limit grinds related to Taxable Capital Employed In Canada and ADJUSTED Aggregate Investment Income.

14-2. After a fairly detailed discussion of the concept of integration, Chapter 13 focused on the taxation of investment income earned by Canadian controlled and other private corporations. Coverage includes the Additional Refundable Tax (ART) on investment income, refundable Part I and Part IV taxes, the designation of eligible dividends, dividend refunds, and both the Eligible RDTOH and the Non-Eligible RDTOH accounts.

14-3. In presenting the material in Chapters 12 and 13, we focused on what we view as basic issues, skipping over some of the more technical considerations related to the determination of corporate Taxable Income and corporate Tax Payable. This was done in the belief that avoiding the more technical aspects would enhance your understanding of the basic procedures associated with these determinations.

14-4. In this Chapter 14, we are turning our attention to these technical issues. In this Chapter we will provide coverage of:

- the acquisition of control rules;
- the associated company rules;
- investment tax credits;
- tax basis shareholders' equity; and
- distributions of corporate surplus, including capital dividends and deemed dividends.

# Acquisition Of Control Rules

## Economic Background

14-5. Over a period of years, some corporations may experience sufficiently large losses that they have no hope of recovering their economic health. While they may have accumulated large amounts of net capital or non-capital loss carry forwards, they have no real prospect of being able to use these amounts. Such companies can become attractive takeover targets for profitable corporations, provided they can structure their business to make use of the tax benefits associated with these losses. For example, if a profitable company can acquire a company for $100,000 that has $1,000,000 in loss carry forwards that can be utilized in the future, it is clearly a bargain for the purchaser. Further, if the acquiree cannot make use of the losses, receiving the $100,000 may be a better alternative than declaring bankruptcy.

14-6. This situation is of concern to the government in that there are billions of dollars of such benefits available in the economy at any point in time. If access to these benefits was relatively trouble-free, the cost to the government could be enormous. As a consequence, the government has enacted legislation which significantly restricts the use of loss carry forwards in situations where there has been an acquisition of control.

## Acquisition Of Control Legislation

14-7. ITA 111(4) through 111(5.5) contain rules that are applicable when there has been an acquisition of control by a person or group of persons. IT-302R3, which deals with the losses of a corporation, indicates that control requires ownership of shares that carry with them the right to elect a majority of the board of directors.

14-8A. An acquisition of control most commonly occurs when a majority shareholder sells his shares to an arm's length person. However, it can also occur through the redemption of shares. For example, if Ms. A owns 75 percent of AB Ltd. and Ms. B, an unrelated person, owns the other 25 percent, there would be an acquisition of control by Ms. B if AB Ltd. was to redeem all of Ms. A's shares.

14-8B. In recent years, several new anti-avoidance rules designed to address loss trading among trusts (ITA 251.2) and using de facto control to avoid the acquisition of control rules (ITA 256.1). The complexity of these rules is beyond the scope of this general text. We would also notes that the *Income Tax Act* now refers to acquisition of control situations as "loss restriction events".

## Deemed Year End

14-9. To prevent losses from being used prior to the end of the taxation year in which the acquisition of control took place, ITA 249(4) requires that the corporation have a deemed year end on the day preceding an acquisition of control.

14-10. If the acquisition of control occurs prior to the corporation's normal year end, a short fiscal period will be created. For example, if the corporation's normal year end was December 31, and the acquisition of control took place on February 1, 2019, the deemed year end would create a fiscal year with only one month (January 1, 2019 through January 31, 2019). Further, if the corporation retains its old year end after the acquisition of control, there will be a second short fiscal year that runs from February 1, 2019 through December 31, 2019.

14-11. Note, however, ITA 249(4) allows the corporation to change its year end when there is an acquisition of control. This means that the corporation could have avoided a second short fiscal period by establishing January 31 as the new year end. This means that the first fiscal year after the acquisition of control will end on January 31, 2020.

14-12. The extra year end is of importance in that the non-capital losses that may be available after the acquisition of control are time limited. In our example, the deemed year end creates, in effect, an extra year end that shortens the period during which time-limited losses can be used. However, with a 20 year carry forward period for non-capital losses, this is unlikely to be an important consideration.

14-13. Other implications of such short fiscal periods include the need to base CCA calculations on a fraction of the year, the need to prorate the annual business limit for the small business deduction, as well as the usual year end procedures such as inclusions of reserves.

### *Restrictions On The Use Of Charitable Donations*

14-14. ITA 110.1(1.2) places two restrictions on the deduction of charitable donations:

- Undeducted amounts that are present at the time of the acquisition of control cannot be carried forward to taxation years subsequent to that date.
- No deduction is available on a gift made subsequent to the acquisition of control if the gifted property was acquired prior to the acquisition date in anticipation of the acquisition of control.

14-15. An example of the latter restriction would be a situation where an individual, who does not have sufficient tax payable to use a credit on the donation of a particular property, transfers that property to a corporation he controls, with the expectation that he will sell the shares in the corporation and the corporation will make the donation and take the deduction.

## Restrictions On The Use Of Losses

### *General Rules*

14-16. The acquisition of control rules apply to any losses that have not been deducted at the deemed year end. This would include losses that have been carried forward from prior years, as well as any additional losses that accrue in the taxation year which is created by the deemed year end.

14-17. As will be explained later, the losses in this deemed taxation year may be increased by provisions that require the recognition of unrealized losses on capital assets. They can also be reduced by gains resulting from an election to have one or more deemed dispositions.

### *Capital Losses*

14-18. The acquisition of control rules are particularly harsh in their treatment of net capital losses. ITA 111(4)(a) indicates that any net capital losses that are present at the deemed year end are simply lost. They cannot be carried forward to future years and, as a consequence, they will be of no benefit to the corporation subsequent to the acquisition of control. Note that this would include any unused Allowable Business Investment Losses that are present at the deemed year end.

14-19. In addition, if there are capital gains in the three years before the deemed year end, ITA 111(4)(b) prevents net capital losses from years subsequent to the deemed year end from being carried back to those years.

### *Non-Capital Losses*

14-20. While non-capital losses can be carried forward, they too are subject to restrictions. These restrictions, found in ITA 111(5), are that:

- after the acquisition of control has taken place, the corporation must continue to carry on the business in which the loss occurred;
- there must be a reasonable expectation of profit in that business; and
- the losses can only be applied against future income generated by the same, or a similar business.

14-21. A brief example can be used to illustrate these provisions:

> **EXAMPLE** Bostox Ltd. operates two separate lines of business, manufacturing cameras and the sale of specialty food products. During the year ending December 31, 2018, the camera business experienced a loss for tax purposes of $5 million, while the food specialty products operation had business income for tax purposes of nil. The $5 million loss could not be carried back and, as a result, it became a loss carry forward. On January 1, 2019, Bostox Ltd. is acquired by another company. During the year ending December 31, 2019, the camera business lost an additional $1 million, while the food products business earned $7 million.

**ANALYSIS** If there was no acquisition of control, both the current 2019 loss of $1 million and the $5 million loss carry forward resulting from the camera business could be deducted against the income of the specialty food products business. This would have resulted in a 2019 Taxable Income of $1 million ($7 million profit on food products, offset by a current loss of $1 million on cameras and a non-capital loss carry forward of $5 million).

However, with the acquisition of control at the beginning of 2019, the loss carry forward can only be used against profits produced by the camera business. This means that none of the loss carry forward can be deducted in 2019, but the $1 million 2019 camera business loss can be netted against the $7 million food products income, resulting in a 2019 Taxable Income of $6 million. The $5 million loss carry forward will still be available, but can only be applied against future camera business income.

## Exercise Fourteen - 1

**Subject:** Acquisition Of Control

India Inc. operates two separate lines of business, one of which sells fountain pens, while the other provides professional accounting services. In its first year of operations ending on December 31, 2018, the pen business had a loss of $192,000, and the accounting business had income of $57,000, resulting in a Net Income For Tax Purposes and Taxable Income of nil. This leaves a non-capital loss carry forward of $135,000. For the taxation year ending December 31, 2019, the pen business had income of $42,000, and the accounting business had income of $247,000, resulting in a Net Income For Tax Purposes of $289,000.

Determine the minimum Taxable Income for 2019 assuming (1) that there was no acquisition of control in either year and (2) that there was an acquisition of control on January 1, 2019. The Company has no deductions from Net Income For Tax Purposes other than possible loss carry forwards from 2018.

**SOLUTION available in print and online Study Guide.**

## Unrecognized Losses At Deemed Year End

### *The Problem*

14-22. As previously indicated, the acquisition of control restrictions apply to losses that accrue in the taxation year that has been created by the deemed year end. As there has been a deemed year end, there may be a loss from normal operations for the fiscal period that has ended. In addition, there may be losses resulting from actual dispositions of capital assets during the period.

14-23. However, the acquisition of control rules are also concerned with accrued losses that have not been recognized at the deemed year end. The problem is that, if such accrued losses are realized after that time, they will not be subject to the acquisition of control restrictions.

**EXAMPLE** A corporation owned a parcel of land with an adjusted cost base of $200,000 and a fair market value of $150,000. If the land was to be disposed of subsequent to the acquisition of control, the result would be a deductible capital loss. This could be viewed as a way of avoiding the restrictions imposed by the acquisition of control rules.

### *Special Rules*

14-24. In recognition of this problem, the acquisition of control rules require a number of special procedures at the deemed year end. They are as follows:

**Non-Depreciable Capital Property** ITA 111(4)(c) requires that non-depreciable capital property be written down to its fair market value, if that value is below its adjusted cost base. ITA 111(4)(d) requires that the amount of the write-down be treated as a capital loss. The new lower value becomes the adjusted cost base of the property. The resulting allowable capital loss can be applied against available taxable capital gains, or carried back. However, if it is not used at the deemed year end, or in the three year carry back period, it is lost forever.

**Depreciable Capital Property** ITA 111(5.1) requires that depreciable capital property be written down to its fair market value, if that value is below the UCC. The write-down amount is treated as CCA to be deducted in the deemed taxation year. This will reduce the income for that period and, in some cases, create or increase the loss for that year. For capital gains purposes, the property will retain the original capital cost.

**Accounts Receivable** ITA 111(5.3) does not permit the deduction of a reserve for doubtful accounts under ITA 20(1)(l). Rather, amounts must be written off as specific bad debts on the basis of the largest possible amount. If a doubtful account is not written off at the time an acquisition of control occurs, no deduction is available if the account subsequently becomes uncollectible. This procedure will generally result in a larger deduction and will reduce income, increase a loss, or create a loss in the deemed taxation year.

### Exercise Fourteen - 2

**Subject:** Write-Downs At Deemed Year End

On November 15 of the current year, Parkat Ltd. acquires control of Sparkat Ltd. On November 14, Sparkat Ltd. has the following assets:

- Land with an adjusted cost base of $293,000 and a fair market value of $215,000.
- Class 8 depreciable assets with a capital cost of $416,000, a UCC balance of $276,000 and a fair market value of $184,000.

Indicate the tax consequences of the procedures that will be applied to these assets in the deemed year end that results from the acquisition of control.

**SOLUTION available in print and online Study Guide.**

## Deemed Disposition Election

### *The Problem*

14-25. The requirement that non-depreciable capital property be written down to fair market value at the deemed year end is particularly onerous in that the resulting capital losses may simply disappear. To offset the harshness of this requirement, ITA 111(4)(e) allows the corporation to elect, at the time of the deemed year end, to have a deemed disposition/reacquisition of any depreciable or non-depreciable capital property on which there is an accrued gain or recapture of CCA. This election can be used to trigger capital gains that will offset either unused losses of the current period or unused loss carry forwards from earlier periods.

14-26. The election can also be used to trigger recapture which can absorb non-capital losses from the current or previous years. This is a less important application in most situations as non-capital losses do not disappear at the deemed year end. However, as noted in Paragraph 14-20, there are restrictions on the use of such losses after the deemed year end. Given this, it may be desirable to minimize non-capital loss carry forwards when an acquisition of control occurs.

### Procedures

14-27. The elected value, which will serve as the deemed proceeds of disposition, cannot exceed the fair market value of the asset at the time of the deemed disposition. The minimum value for the election is the adjusted cost base or capital cost of the property. The elected value can be any amount between this minimum and maximum. This means that, in the case of property on which CCA has been taken, any election that will create a capital gain will also create recapture of CCA.

14-28. If the corporation has net capital losses and there are non-depreciable properties with accrued gains, this election is clearly desirable in that it will generate capital gains, which can be used to offset the net capital losses that would disappear as a result of the acquisition of control.

14-29. The situation is less clear cut when the gains are on depreciable capital property. While the deemed disposition will create the needed capital gains, it will generally result in recapture of CCA. This may or may not be a desirable situation.

### Example

14-30. The following example will illustrate the procedures associated with the ITA 111(4)(e) deemed disposition election:

> **EXAMPLE** Burkey Ltd. has a December 31 year end. On June 1, 2019, a new investor acquires control of the Company. While its basic operations have been profitable for many years, it has a net capital loss carry forward of $200,000 [(1/2)($400,000)]. On May 31, 2019, the Company has non-depreciable capital assets with a fair market value of $800,000 and an adjusted cost base of $500,000. Its depreciable capital assets have a fair market value of $1,200,000, a capital cost of $1,100,000, and a UCC of $600,000.
>
> **ANALYSIS** The ITA 111(4)(e) election is clearly desirable with respect to the non-depreciable capital property. It generates a taxable capital gain of $150,000 [(1/2)($800,000 - $500,000)]. Deducting a $150,000 carry forward against this 2019 gain will use up $150,000 of the net capital loss. This will leave an unused amount of $50,000 ($200,000 - $150,000).
>
> Using the ITA 111(4)(e) election on the depreciable capital property will create a $50,000 [(1/2)($1,200,000 - $1,100,000)] taxable capital gain. Deducting a $50,000 loss carry forward against this amount will use up the remaining $50,000 of the net capital loss balance. However, the election will also create recaptured CCA of $500,000 ($1,100,000 - $600,000), an amount on which it appears that tax would have to be currently paid. Given that, in the absence of this election, taxation on the recapture could be deferred indefinitely, the election may not be desirable with respect to the depreciable capital property. One other factor that should be considered is that the election would result in increased CCA in the future.

### Adjusted Cost Base After Election

14-31. In addition to serving as the deemed proceeds of disposition, the elected value also becomes the adjusted cost base or capital cost of the asset on which the election was made. If the elections were made at fair market value on both properties in the preceding example, the new adjusted cost base of the non-depreciable assets would be $800,000, while the capital cost of the depreciable assets would be $1,200,000.

14-32. However, if the $1,200,000 value was allowed to be used for CCA purposes, the Company would be able to deduct 100 percent of the $100,000 difference between the $1,200,000 elected value and the old capital cost of $1,100,000, despite the fact that they have, in effect, paid tax on only one-half of this amount.

14-33. To prevent this from happening, ITA 13(7)(f) specifies that, when an election is made under ITA 111(4)(e), the new capital cost of the property for CCA purposes only, is equal to the original capital cost of the asset, plus one-half of the excess of the elected value over the

asset's original capital cost. In the example in Paragraph 14-30, this value would be \$1,150,000 [\$1,100,000 + (1/2)(\$1,200,000 - \$1,100,000)]. You might recall that other paragraphs in ITA 13(7) contain the same rule for both non-arm's length transfers of depreciable property and for some changes in use.

14-34. Future CCA would be based on this \$1,150,000 figure and, in addition, if the assets were sold for more than \$1,150,000, the \$1,150,000 would be subtracted from the UCC to determine any recapture. However, any future capital gain would be based on the new adjusted cost base of \$1,200,000.

## Exercise Fourteen - 3

**Subject:** Election On Acquisition Of Control

Means Ltd. has a December 31 year end. On May 1, 2019, all of the Company's shares are acquired by a new owner. For the period January 1, 2019 through April 30, 2019, the Company has an operating loss of \$45,000. On April 30, 2019, the Company has available a net capital loss carry forward of \$110,000 [(1/2)(\$220,000)]. Also at that time, the Company has the following assets:

| Asset Type | Adjusted Cost Base Or Capital Cost | UCC | Fair Market Value |
|---|---|---|---|
| Non-Depreciable | \$500,000 | N/A | \$650,000 |
| Depreciable | 400,000 | 350,000 | 500,000 |

Advise the Company with respect to the most appropriate elections to be made prior to the acquisition of control and explain your results.

**SOLUTION available in print and online Study Guide.**

**We suggest you work Self Study Problems Fourteen-1 and 2 at this point.**

# Associated Companies

## The Problem

14-35. In the absence of special rules, it would be very easy to avoid the annual limit that applies to the small business deduction. This could be accomplished by dividing a single corporation's activities between two separate corporations, thereby doubling up on the annual business limit of \$500,000. However, as was noted in Chapter 12, the *Act* makes this more difficult by requiring that associated companies share their annual business limit.

14-36. For example, assume that Mr. Robards owns all of the outstanding voting shares of both the Mark Company and the Grand Company. These two Companies would be considered to be associated and, as a consequence, would have to share the \$500,000 annual business limit. As was indicated in Chapter 12, they can elect to allocate the annual limit in any proportion they wish, provided the total does not exceed \$500,000. If the Mark Company has active business income and the Grand Company does not, it would be most advantageous to allocate the entire annual limit to the Mark Company, so that it could claim the maximum small business deduction.

14-37. The preceding example is very clear cut and results in an allocation of the small business deduction that reflects the goals of the relevant legislation. However, with a deduction that can be worth \$95,000 [(19%)(\$500,000)] per year in federal tax alone, there is a significant incentive to develop arrangements that will avoid the intent of the legislation. Correspondingly, there is a need to have legislation that is sophisticated enough to frustrate these arrangements. As a consequence, the identification of associated companies can be very complex.

# Definitions

## Related Persons

14-38. ITA 251 provides definitions of related persons. The legislation for identifying associated companies makes much use of these definitions. Given this, working with the associated companies rules requires an understanding of the related persons rules. Note, however, you are dealing with two different concepts. ITA 251 deals with all classes of related taxpayers, while ITA 256 deals only with corporations. Further, even with corporations, the terms related and associated have different meanings.

14-39. The more important of the related persons definitions are as follows:

**ITA 251(2)(a) - Related Persons** With respect to individuals, Paragraph (a) notes that individuals are related if they are connected by blood relationship, marriage, common-law partnership, or adoption. Various other Subsections in ITA 251 and 252 elaborate on this statement to point out that all of the following individuals would be "related" to the taxpayer:

- Parents and grandparents, as well as parents and grandparents of the taxpayer's spouse or common-law partner.
- The taxpayer's spouse or common-law partner, as well as the spouse or common-law partner's siblings and their spouses and common-law partners.
- Siblings of the taxpayer, as well as spouses or common-law partners of the taxpayer's siblings.
- Children, including those that are adopted, or born outside of marriage. Also included here would be spouses and common-law partners of children and children of the taxpayer's spouse or common-law partner.

**ITA 251(2)(b)** indicates that a corporation is related to:

- a person who controls it, if it is controlled by one person;
- a person who is a member of a related group that controls it; or
- any person related to a person who controls it or who is related to a member of a related group that controls it.

**ITA 251(2)(c)** indicates that two corporations are related if:

- they are controlled by the same person or group of persons;
- each of the corporations is controlled by one person and the person who controls one of the corporations is related to the person who controls the other corporation;
- one of the corporations is controlled by one person and that person is related to any member of a related group that controls the other corporation;
- one of the corporations is controlled by one person and that person is related to each member of an unrelated group that controls the other corporation;
- any member of a related group that controls one of the corporations is related to each member of an unrelated group that controls the other corporation; or
- each member of an unrelated group that controls one of the corporations is related to at least one member of an unrelated group that controls the other corporation.

## Associated Companies

14-40. The definitions that relate directly to identification of associated companies are found in the ITA 256. The more important of these are as follows:

**ITA 256(1.1) - Specified Class, Shares Of** In simplified terms, this definition refers to non-voting shares that have a fixed dividend rate and redemption amount. Such shares are commonly referred to as preferred shares.

**ITA 256(1.2)(a) - Definition Of Group** For purposes of defining associated companies, a group is two or more persons, each of whom owns shares in the corporation in question. A related group involves a group of persons, each member of which is related to every other member. ITA 251(4) notes that a related group is a group of

persons, each member of which is related to every other member. An unrelated group is any group, other than a related group.

**ITA 256(1.2)(c) - Control** The definition of associated corporations also involves the concept of control. For purposes of determining association, a corporation is deemed to be controlled by another corporation, a person, or a group of persons, if the corporation, person, or group of persons owns either:

- shares (common and/or preferred) of capital stock with a fair market value of more than 50 percent of all issued and outstanding shares of capital stock; or
- common shares with a fair market value of more than 50 percent of all issued and outstanding common shares.

This definition is based on legal control. Control can also be "Control In Fact" as described in ITA 256(5.1) or control through other corporations as described in ITA 256(6.1) and 256(6.2).

**Deeming Rules** The most relevant deeming rules can be described as follows:

- **ITA 256(1.2)(d) - Holding Companies** This provision indicates that where shares of a corporation are held by another corporation, a shareholder of the holding corporation is deemed to own the shares of the held corporation in proportion to his interest in the holding corporation. Similar provisions apply to shares held by partnerships and trusts. Note, however, if a holding corporation holds a controlling interest in an investee, the holding corporation is considered to control all of the shares held by that investee.
- **ITA 256(1.3) - Children Under 18** This provision requires that shares of a corporation owned by a child under the age of 18 be deemed to be owned by a parent of the child for the purpose of determining whether the corporation is associated with any other corporation that is controlled by that parent or a group that includes that parent.
- **ITA 256(1.4) - Rights And Options** This provision requires that rights to acquire shares be treated as though they were exercised for purposes of determining associated companies. This Subsection also indicates that, where a person has a right to require a shareholder to redeem, cancel, or acquire its own shares, for purposes of determining association, the corporation is deemed to have carried out the redemption, cancellation, or acquisition.
- **ITA 256(1.5) - Person Related To Himself, Herself, Or Itself** This provision indicates that, where a person owns shares in two or more corporations, the person shall as shareholder of one of the corporations be deemed to be related to himself, herself or itself as shareholder of each of the other corporations.

**ITA 256(2) - Association Through A Third Corporation** This provision indicates that two corporations, both of which are associated with a third corporation, are deemed to be associated with each other. This Subsection also includes an election that can mitigate this rule. The third corporation can elect to not be associated with the other two corporations. A consequence of this is that the third corporation's annual business limit will be set at nil. However, the election will allow the other two corporations to be exempt from the association rules under ITA 256(2).

14-41. Given these definitions and rules, we are now in a position to look at the definition of associated companies as it is found in ITA 256(1).

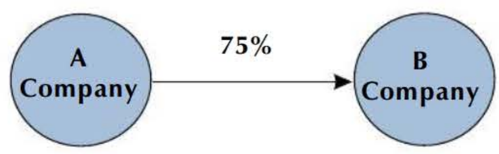
## Examples - Associated Corporation Rules

14-42. The preceding definitions are essential to the understanding of the associated corporation rules found in ITA 256(1). This Subsection contains five Paragraphs designated (a) through (e), with each Paragraph describing a relationship involving association. These five Paragraphs will be given individual attention in the material that follows.

14-43. The first of these paragraphs indicates that one corporation is associated with another in a taxation year if, at any time in the year;

> **ITA 256(1)(a)** one of the corporations controlled, directly or indirectly in any manner whatever, the other.

**Figure 14 - 1 [ITA 256(1)(a)]**

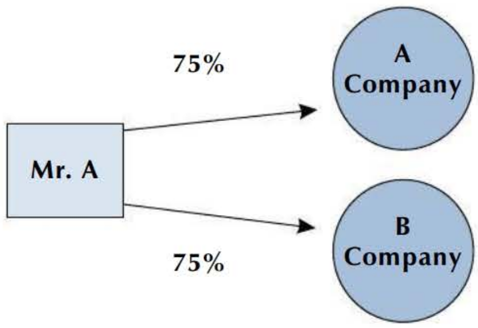



14-44. This type of association can be illustrated by the situation shown in Figure 14-1 in which A Company owns 75 percent of the outstanding voting shares of B Company. In this situation, Company A and Company B are associated by virtue of ITA 256(1)(a).

14-45. The second Paragraph in ITA 256(1) indicates that one corporation is associated with another in a taxation year if, at any time in the year;

> **ITA 256(1)(b)** both of the corporations were controlled, directly or indirectly in any manner whatever, by the same person or group of persons.

**Figure 14 - 2 [ITA 256(1)(b)]**

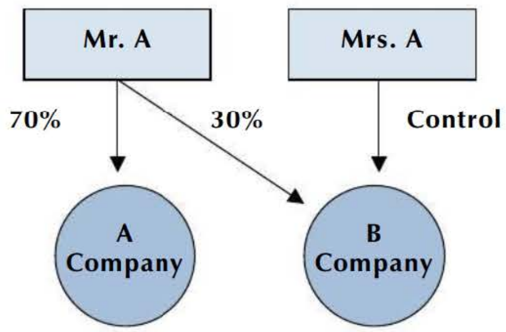



14-46. This type of association can be illustrated by the situation shown in Figure 14-2. In this situation, Mr. A owns 75 percent of the voting shares of both A Company and B Company. As a consequence, these two Companies are associated by virtue of ITA 256(1)(b), in that they are both controlled by the same person.

14-47. The third Paragraph in ITA 256(1) indicates that one corporation is associated with another in a taxation year if, at any time in the year;

> **ITA 256(1)(c)** each of the corporations was controlled, directly or indirectly in any manner whatever, by a person and the person who so controlled one of the corporations was related to the person who so controlled the other and either of those persons owned, in respect of each corporation, not less than 25 percent of the issued shares of any class, other than a specified class, of the capital stock thereof.

**Figure 14-3 [ITA 256(1)(c)]**

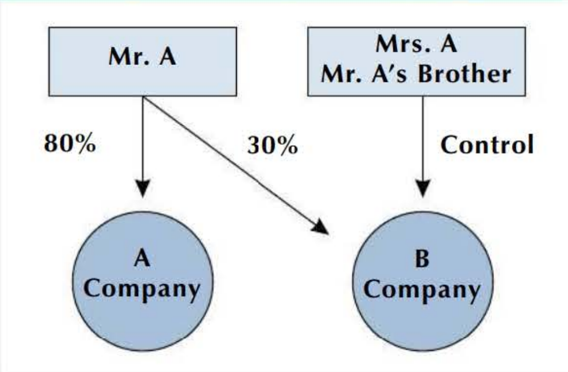



14-48. This type of association can be illustrated by the situation shown in Figure 14-3. In this situation, Mr. A owns 70 percent of the voting shares of A Company and his spouse, Mrs. A, owns 70 percent of the voting shares of B Company. In addition, Mr. A owns not less than 25 percent of the shares of B Company. Provided that the B Company shares owned by Mr. A are not of a specified class, Companies A and B are associated under ITA 256(1)(c). As the required cross ownership can be in either direction, the two Companies would also be associated if the cross ownership was by Mrs. A in A Company.

14-49. The fourth Paragraph in ITA 256(1) indicates that one corporation is associated with another in a taxation year if, at any time in the year;

**ITA 256(1)(d)** One of the corporations was controlled, directly or indirectly in any manner whatever, by a person and that person was related to each member of a group of persons that so controlled the other corporation, and that person owned, in respect of the other corporation, not less than 25 percent of the issued shares of any class, other than a specified class, of the capital stock thereof.

**Figure 14-4 [ITA 256(1)(d)]**

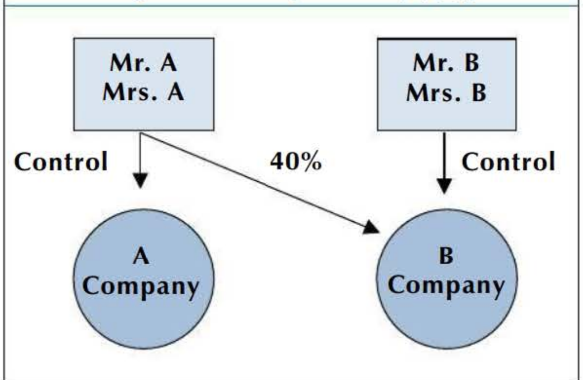



14-50. This type of association can be illustrated by the situation in Figure 14-4. In this situation, Mr. A owns 80 percent of the voting shares of A Company, while Mrs. A and Mr. A's brother each own 35 percent (70 percent in total) of the voting shares of B Company. This means that Mr. A is related to each member of a group that controls B Company. Mr. A also has the required cross ownership, in that he owns 30 percent of the shares of B Company. Provided that the shares of B Company owned by Mr. A are not of a specified class, A Company and B Company are associated by virtue of ITA 256(1)(d). Note that, under ITA 256(1)(d), the cross ownership has to be by Mr. A in B Company. If the cross ownership was in the other direction (e.g., Mrs. A owns 30 percent of A Company), the two Companies would not be associated under ITA 256(1)(d).

14-51. The final Paragraph in ITA 256(1) indicates that one corporation is associated with another in a taxation year if, at any time in the year;

**ITA 256(1)(e)** Each of the corporations was controlled, directly or indirectly in any manner whatever, by a related group and each of the members of one of the related groups was related to all of the members of the other related group, and one or more persons who were members of both related groups, either alone or together, owned, in respect of each corporation, not less than 25 percent of the issued shares of any class, other than a specified class, of the capital stock thereof.

**Figure 14-5 [ITA 256(1)(e)]**




14-52. This type of association can be illustrated by the situation in Figure 14-5. Mr. and Mrs. A are a related group that control A Company, and Mr. and Mrs. B are a related group that control B Company. If we assume that Mrs. B is Mr. A's sister, then each member of one related group is related to all of the members of the other related group. Mr. and Mrs. A each own 50 percent of the voting shares of A Company, Mr. and Mrs. B each own 30 percent of the voting shares of B Company. Mr. A owns the remaining 40 percent of the voting shares of B Company. In this situation, A Company and B Company are associated under ITA 256(1)(e). Once again, Mr. A's cross ownership has to be shares other than those of a specified class. However, if A Company shares were available, the cross ownership could be in the other direction (e.g., Mrs. B owns not less than 25 percent of A Company).

**Exercise Fourteen - 4**

**Subject:** Associated Companies

The Top Company owns 65 percent of the shares of Middle Company, as well as 10 percent of the shares of Bottom Company. Middle Company owns 35 percent of the shares of Bottom Company. Mr. Top, who owns all of the shares of Top Company, also owns 5 percent of the shares of Bottom Company and has options in those shares that would, if exercised, increase his ownership by another 10 percent. Mr. Top's 12 year old son owns 15 percent of the Bottom Company shares. Indicate which of these Companies are associated, citing the relevant provisions of the *Income Tax Act*.

**SOLUTION available in print and online Study Guide.**

**We suggest you work Self Study Problems Fourteen-3 and 4 at this point.**

# Investment Tax Credits

## Background

14-53. In terms of directing economic incentives to specific regions or types of activities, investment tax credits are a very effective tax policy tool. They can be used to provide tax reductions that are very specifically targeted (e.g., scientific research expenditures). In addition, by making some of them refundable, they can even provide benefits for enterprises with no Tax Payable.

14-54. Despite their advantages in terms of targeting benefits, the use of investment tax credits has declined over the last 10 to 20 years. At one time, they were applicable to large classes of assets in broadly defined regions of Canada. At present, their use is confined to specific targeted areas. The ones that we will discuss in this Chapter are credits for salaries of eligible apprentices, current expenditures for scientific research, and the cost of qualified property.

## Procedures

14-55. Investment tax credits are tax incentives that are available to Canadian taxpayers who are earning business income or undertaking scientific research and experimental development. With some exceptions, they are available on the same terms for corporations as they are for individuals.

14-56. In general terms, the procedures for investment tax credits, which are contained in ITA 127(5) through ITA 127.1(4), allow the taxpayer to deduct a specified percentage of the cost of certain types of current and capital expenditures from federal Tax Payable. The credits provide for a direct reduction in the amount of tax that is payable.

14-57. When capital expenditures are involved, the amount of the investment tax credit must be removed from the capital cost of the asset, so that only the net capital cost is deductible through capital cost allowances (CCA). The legislation is such that the deduction from capital cost occurs in the taxation year following the year in which credit is claimed.

14-58. The capital cost must also be reduced by any government or non-government assistance received or receivable for the property, such as grants or subsidies. However, the reduction for these other types of assistance is made in the year in which the assistance is received or receivable.

14-59. When the investment tax credits are earned by making deductible current expenditures, the credits will be added to income in the following year.

14-60. In effect, the tax mechanism that is involved with investment tax credits is that the enterprise gives up $1 of current or future tax deductions, in return for a $1 reduction in the

amount of Tax Payable. This is clearly beneficial in that the cost of losing a $1 deduction is only $1 multiplied by the company's tax rate, a figure that could be below $0.15. By contrast, $1 of reduced tax payable is a cash flow savings of $1.

## Eligible Expenditures

14-61. To provide a general picture of the applicability of investment tax credits, brief descriptions are provided of expenditures that qualify for these credits:

**Salaries And Wages Of An Eligible Apprentice** An eligible apprentice is defined in ITA 127(9) and can be described as follows:

> **Eligible apprentice** means an individual who is employed in Canada in a prescribed trade (a trade currently listed as a "Red Seal Trade") in the first two years of their apprenticeship contract. This contract must be registered with a federal, provincial or territorial government under an apprenticeship program designed to certify or license individuals in the trade.

**Qualified Property** is defined in ITA 127(9) with further elaboration provided in ITR 4600 and 4601. As presented in this material, qualified property must be newly acquired primarily for use in Canada, and it must be available for use in specified activities. These activities include manufacturing and processing, logging, farming or fishing, and storing grain.

**Qualified Scientific Research And Experimental Development (SR&ED) Expenditures** includes current expenditures for basic or applied research, and for the development of new products and processes. (Capital expenditures do not qualify for SR&ED credits.) The rules related to SR&ED expenditures are extremely complex and the application of these rules goes beyond the scope of this introductory text. As a result, we provide only very limited coverage of this topic and do not include coverage of what qualifies as SR&ED expenditures.

## Rates

### *General*

14-62. Current rates for the investment tax credits that we have described are as follows:

| Type Of Expenditure | Rate |
|---|---|
| Salaries And Wages Of Eligible Apprentices | |
| (Limited To The First $20,000 Of Salaries And Wages For Each Apprentice) | 10% |
| Qualified Property | |
| In Atlantic Provinces And Gaspe Peninsula | 10% |
| Prescribed Offshore Regions (East Coast) | 10% |
| Rest Of Canada | Nil |
| Scientific Research And Experimental Development | |
| Incurred By Any Taxpayer | 15% |
| Incurred By CCPCs (See Paragraph 14-63) | 35% |

## Exercise Fourteen - 5

**Subject:** Investment Tax Credit Procedures

During 2019, Colus Inc. pays salaries to five eligible apprentices totalling $125,000 ($25,000 per apprentice). In addition, it acquires $3,000,000 in Class 53 assets on which a 10 percent investment tax credit is available. Describe the 2019 and 2020 tax consequences associated with making these expenditures and claiming the related investment tax credits. Include in your solution the CCA for 2019 and 2020.

**SOLUTION available in print and online Study Guide.**

### *Special Rate On SR&ED Expenditures By CCPCs*

14-63. With respect to the 35 percent rate for SR&ED expenditures, this overall rate results from providing an additional 20 percent for some expenditures made by a corporation that is a CCPC throughout a taxation year under ITA 127(10.1). Special provisions are available on up to $3 million in qualifying expenditures.

14-64. Prior to the March 19, 2019 federal budget, the $3 million limit could be reduced if the preceding year's Taxable Income was in excess of $500,000, and/or if the preceding year's Taxable Capital Employed In Canada was greater than $10 million. The 2019 budget eliminated the Taxable Income constraint. For taxation years that end after March 18, 2019, the ITA 127(10.2) limitation is as follows:

**Annual Expenditure Limit** = [$3,000,000][($40,000,000 – **A**) ÷ $40,000,000]

where **A** is

(a) nil, if the corporation's Taxable Capital Employed In Canada, along with the Taxable Capital Employed In Canada of any associated companies, is less than $10 million for the immediately preceding year.

(b) in any other case, the lesser of $40 million and the amount by which the corporation's Taxable Capital Employed In Canada, along with the Taxable Capital Employed In Canada of any associated companies, exceeds $10 million.

14-65. If a CCPC and its associated companies has previous year Taxable Capital Employed In Canada of less than $10 million, the limit on which the 35 percent investment tax credit will be applicable is $3 million. If the CCPC's Taxable Capital Employed In Canada for the preceding year exceeds $10 million, the limit will be reduced by $3 for every $40 of the excess. It will be completely eliminated when the Taxable Capital Employed In Canada for the preceding year reaches $50 million as shown in the following calculation:

$$[\$3 \text{ Million}]\left[\frac{\$40 \text{ Million} - (\$50 \text{ Million} - \$10 \text{ Million})}{\$40 \text{ Million}}\right] = \text{Nil}$$

## Exercise Fourteen - 6

**Subject:** SR&ED Credits For CCPCs

Anfax has been a CCPC since it began operations and has a taxation year ending on December 31. It has no associated companies. Its Taxable Capital Employed In Canada equaled $12,500,000 for 2018 and $11,500,000 for 2019.

Determine its annual SR & ED expenditure limit for 2019.

**SOLUTION available in print and online Study Guide.**

## Refundable Investment Tax Credits

### *General Rules - 40 Percent Refund*

14-66. A problem with tax credits is that, in general, they have value only when the taxpayer has a tax liability. To deal with this problem, some tax credits are "refundable". What this means is that, when a taxpayer has earned a tax credit and does not have sufficient Tax Payable to use it in full, the government will pay ("refund") all or part of the unused amount to the taxpayer. We have encountered this type of situation previously for individuals with respect to the refundable medical expense supplement tax credit (see Chapter 4).

14-67. A refund can be made for up to 40 percent of the investment tax credits earned by a taxpayer, provided the taxpayer is:

- an individual;
- a "qualifying corporation", which is a Canadian controlled private corporation throughout the year with Taxable Income in the previous year, less an adjustment for Taxable Capital Employed In Canada (which is the same as the one illustrated in Paragraph 14-65), that is $500,000 or less before loss carry backs; or
- a trust where each beneficiary is an individual or a qualifying corporation.

14-68. This means that if an individual had $1,000,000 in SR&ED current expenditures, he would be eligible for a $150,000 [(15%)($1,000,000)] investment tax credit. If the individual did not have sufficient Tax Payable in the current year or the three previous years to use this credit, there would be a refund (payment) of up to $60,000 [(40%)($150,000)].

### *Additional Refund - 100 Percent Refund*

14-69. In the case of a qualifying corporation, additional amounts are refundable. To the extent that current SR&ED expenditures are eligible for the 35 percent investment tax credit, the resulting credit is eligible for a 100 percent refund. This means that a qualifying corporation that spends $3,000,000 on current SR&ED expenditures is eligible for a refund payment of up to $1,050,000 [(35%)($3,000,000)] from the government (qualifying corporations are described in Paragraph 14-67).

14-70. The 100 percent refund is only available on the first $3,000,000 of expenditures that qualify for the 35 percent investment tax credit. We would remind you that capital expenditures do not qualify for SR&ED credits.

## Carry Overs Of Investment Tax Credits

14-71. Under the definition of investment tax credit in ITA 127(9), unused investment tax credits may be carried back for up to 3 years and forward for 20 years. A taxpayer is required to claim all other available tax credits before calculating and claiming the investment tax credit for the year. Also, a taxpayer must reduce, to the fullest extent possible, federal Tax Payable for the current year before using investment tax credits to reduce previous years' federal Tax Payable.

### Exercise Fourteen - 7

**Subject:** Refundable Investment Tax Credits

Sci-Tech Inc. has made a number of expenditures that qualify for investment tax credits. They have invested $123,000 in Qualified Property in Nova Scotia. In addition, they have $1,200,000 in current expenditures for scientific research and experimental development. The Company is a Canadian controlled private corporation and, for the previous taxation year, has Taxable Income of $176,000 and Taxable Capital Employed In Canada of $6,000,000. The Company has no Tax Payable for the current year or the three previous years.

Determine the amount of the refund that Sci-Tech will receive as a result of earning these investment tax credits and any available carry forwards. Include in your answer any other tax consequences of these investment tax credits.

**SOLUTION available in print and online Study Guide.**

**We suggest you work Self Study Problem Fourteen-5 at this point.**

### Effect Of Acquisition Of Control On Investment Tax Credits

14-72. As was the case with companies having accumulated loss carry forwards, the government is concerned about the large amount of unused investment tax credits that are being carried forward in the tax records of Canadian corporations. The carry forwards reflect the fact that these corporations have experienced losses and, as a consequence, have not had a tax liability to which the non-refundable credits could be applied.

14-73. While the government does not object to these credits being used against Tax Payable resulting from improved profitability for the corporations that have experienced losses, there is concern that these loss corporations will be acquired by profitable corporations in order to make use of these credits. As a consequence, there are acquisition of control rules that apply to the carry forward of investment tax credits.

14-74. These rules are found in ITA 127(9.1) and (9.2). Their effect was described in the cancelled IT-151R5, Scientific Research and Experimental Development Expenditures as follows:

> If control of a corporation has been acquired ... subsection 127(9) may apply to restrict the availability of the corporation's investment tax credits. In general, these provisions limit the application of investment tax credits to the tax on the income from a particular business carried on by the corporation before the acquisition of control or any other business substantially all the income of which is from the sale, leasing, rental, or development of properties or the rendering of services similar to those of the particular business carried on by the corporation before the acquisition of control.

14-75. As you can see, the effect of these provisions is to treat investment tax credits in a manner similar to the treatment of non-capital loss carry forwards when there is an acquisition of control.

## Tax Basis Shareholders' Equity

### Shareholders' Equity Under GAAP

14-76. In this Chapter, we will be considering various distributions to shareholders. In order to comprehend this material, some understanding of the tax basis components of shareholders' equity is required.

14-77. You should be familiar with the components of Shareholders' Equity as they appear in a Balance Sheet prepared using generally accepted accounting principles (GAAP). The two basic components of the total balance disclosed are:

> **Contributed Capital** This is the amount that has been paid by investors in return for shares issued. In jurisdictions where par value shares can still be used, this balance may be divided into par value amounts and an excess over par amount, commonly designated contributed surplus.
>
> **Earned Capital (Retained Earnings)** This component reflects amounts that have been earned by the corporation and retained in the business. While this balance is sometimes referred to as earned surplus, the more common designation is retained earnings. In some situations, part of this balance may be designated as reserves.

14-78. This segregation into contributed and earned capital is based on the general legal requirement that dividends cannot be paid out of contributed capital. By using this disclosure, investors are informed as to the legal basis for payment of dividends by the corporation. However, this legal basis may not be supported by the cash resources that would be needed to, in fact, pay cash dividends.

### Paid Up Capital (Tax Basis Contributed Capital)

14-79. ITA 89(1) defines paid up capital, normally referred to as "PUC". This Subsection indicates that the amount should be calculated without reference to the *Income Tax Act*,

telling us that PUC should be based on legal stated capital as determined under the legislation governing the particular corporation (*Canada Business Corporations Act* or relevant provincial legislation). As contributed capital under GAAP is also based on legal stated capital, the initial PUC for shares issued will generally be equal to contributed capital under GAAP. However, as will be discussed in this and subsequent Chapters, there will be adjustments to PUC that have no equivalent adjustment under GAAP.

14-80. PUC is applied on an average per share basis to each class of shares. This means, for example, that if a corporation issues 100,000 shares to one individual at $10 per share and, at a later point in time, issues an additional 100,000 shares of the same class to a different individual at $15 per share, the per share PUC will be $12.50 for all of the shares of that class. Stated alternatively, all shares of a particular class will have the same per share PUC value.

14-81. Note the difference between the PUC value per share and the adjusted cost base (ACB) of a share. The ACB of a share is the average cost of the shares held by a particular shareholder. In the example in Paragraph 14-80, the taxpayer acquiring the first issue has an adjusted cost base of $10 per share, while the purchaser of the second issue has an adjusted cost base of $15 per share.

14-82. The importance of PUC lies in the fact that it is a capital contribution and does not reflect accumulated earnings of the corporation. Because of this, it can be distributed to shareholders as a return of capital (subject to any restrictions imposed by corporate law), without tax consequences for either the corporation, or the shareholder. This may not be the case, however, when capital distributions are made to shareholders of public corporations.

### Exercise Fourteen - 8

**Subject:** Determination Of PUC And Adjusted Cost Base

Halide Ltd. has one class of shares. The Company issued its first 100,000 shares at a price of $1.10 each. Two years later, an additional 50,000 shares were issued for $1.35 per share. During the current year, a further 30,000 shares were issued for $1.82 per share. One of the investors in the Company acquired 2,400 shares of the first group of shares issued, and an additional 3,850 shares from the most recent issue. Determine the adjusted cost base per share, as well as the total PUC of this investor's shares.

**SOLUTION available in print and online Study Guide.**

## Tax Basis Retained Earnings

### *Amount*

14-83. The situation with respect to Retained Earnings is much more complex. To begin, we will be dealing with a different total for tax purposes. As you are aware, there are significant differences between accounting Net Income and Net Income For Tax Purposes.

14-84. While the accounting literature defines accounting/tax differences as temporary differences with reference to Balance Sheet accounts (e.g., the difference between the Net Book Value and the UCC of a depreciable asset), most of these Balance Sheet differences are created by Income Statement differences (e.g., the difference between Amortization Expense and CCA). As a result, total Retained Earnings as determined under GAAP will, in most cases, be a significantly different number than the corresponding tax figure.

14-85. A further point here relates to terminology. In general, the term Retained Earnings has replaced Earned Surplus in accounting literature and in published financial statements. However, the term surplus is still alive and well in tax work. As evidence, we would note that the *Income Tax Act* contains only 5 references to Retained Earnings, in contrast to 44 references to Surplus.

### Basic Components

14-86. Moving beyond the differences in the total amount, we encounter further problems in relating tax and GAAP figures. Under GAAP, Retained Earnings is often a single homogeneous balance. While some companies still segregate parts of this balance into reserves, such components have no formal meaning beyond assisting with disclosure.

14-87. In contrast, the corresponding tax balance has four components, each with a well defined role in tax work. The four components are as follows:

- Capital Dividend Account (private companies only)
- Post-1971 Undistributed Surplus
- Pre-1972 Undistributed Surplus (no longer covered in this text)
- Pre-1972 Capital Surplus On Hand (no longer covered in this text)

14-88. The Capital Dividend Account is only available to private companies. It is discussed in detail in this Chapter beginning at Paragraph 14-92.

14-89. "Post-1971 Undistributed Surplus" tracks the earnings retained after 1971 that do not have any special tax status.

14-90. In Chapter 8 we noted that, prior to 1972, capital gains were not subject to tax in Canada. The 1972 introduction of capital gains taxation resulted in the need to have a complex set of transitional rules to avoid taxation of gains accrued prior to that date. Although at one time these rules were very important, with the passage of time this is no longer the case.

14-91. "Pre-1972 Undistributed Surplus" is simply earnings that accrued prior to 1972 that are retained in the corporation. The "Pre-1972 Capital Surplus On Hand" tracks capital gains and losses that accrued prior to 1972, but were realized after 1971. Such transactions are no longer of sufficient importance to warrant coverage in a general text such as this.

## Capital Dividend Account (CDA)

### Objective

14-92. The objective of the Capital Dividend Account (CDA) is to track items that can be distributed on a tax free basis to the shareholders of the corporation. While a number of different items can be included in this account, the reason for its use can best be understood in the context of capital gains.

> **EXAMPLE** During 2016, Uval Ltd. acquires land at a cost of $150,000. During 2019, the land is sold for $190,000, resulting in a capital gain of $40,000 ($190,000 - $150,000).
>
> **ANALYSIS** It is the intent of tax legislation to assess tax on only one-half of capital gains. This means that Uval will have a taxable capital gain of $20,000 [(1/2)($40,000)]. However, the remaining $20,000 is still being held by the corporation. While the goal of tax legislation is not to have taxes assessed on this balance, in the absence of some special provision, its distribution would be subject to tax in the hands of the recipient shareholders.

14-93. The CDA provides the required relief in this situation. The untaxed balance of $20,000 will be added to the CDA. This balance can then be used to pay a capital dividend, a special type of dividend that can be distributed tax free to the shareholders of the corporation. Such dividends will be discussed in more detail at a later point in this chapter.

14-94. While this analysis would appear to be relevant to all types of corporations, only private corporations can have a CDA. Note, however, the use of this account is available to private corporations, without regard to whether they are Canadian controlled.

### Procedures

14-95. As indicated in the preceding section, there are a number of different items that can be allocated to the capital dividend account. The complete definition of these items is found

in ITA 89(1) and is very complex. Without becoming involved in some of the more complex issues found in that Subsection, the basic components of the CDA are as follows:

**Capital Dividends Received** Capital dividends received from other corporations are added to the CDA. This preserves the tax free status of non-taxable amounts that pass through more than one corporation.

**Capital Gains** The non-taxable portion of realized net capital gains are accumulated in the CDA account, with this balance being reduced by the non-deductible portion of realized capital losses (this would include 100 percent of the gain on publicly traded shares that have been gifted to a registered Canadian charity).

Note that this component of the CDA cannot become negative and reduce the aggregate amount of the other CDA components, like capital dividends received.

**EXAMPLE** In 2014, a resident private corporation realizes a capital loss of $15,000, the non-deductible portion of which is $7,500. In 2016, it realizes a capital gain of $10,000, the non-taxable portion of which is $5,000. In 2019, it receives a capital dividend of $1,000.

**ANALYSIS** While the net of the capital gains component of the CDA is a negative amount of $2,500, the balance of this component in the CDA would be nil. The overall balance in the CDA is $1,000 (the capital dividend received).

**Life Insurance Proceeds** Life insurance proceeds received by the corporation are added to the account, net of the adjusted cost base of the policy. This can be an important addition when the company insures the life of one or more of its shareholders. This is a common procedure in owner-managed businesses, where life insurance proceeds are sometimes used to finance the buyout of the shares from the estate of a deceased shareholder.

**Capital Dividends Paid** The account is reduced by capital dividends paid. As will be discussed in Paragraph 14-111, an ITA 83(2) election is required.

## Exercise Fourteen - 9

**Subject:** Capital Dividend Account

The following transactions involve the Knerd Corporation's capital dividend account:

- In 2017, they sold land with an adjusted cost base of $86,000, for cash of $108,000.
- During the year ending December 31, 2018, the Company received a capital dividend of $8,200.
- On July 15, 2019, they sold goodwill for proceeds of $43,000. The goodwill had been internally developed and was not reflected in the Company's records. On January 1, 2019, there was a nil balance in the Company's Class 14.1 UCC.
- On October 31, 2019, the Company paid an ITA 83(2) capital dividend of $16,000. The appropriate election was made.

Determine the balance in the capital dividend account at December 31, 2019.

**SOLUTION available in print and online Study Guide.**

**We suggest you work Self Study Problems Fourteen-6 and 7 at this point.**

# Distributions Of Corporate Surplus

## Introduction

14-96. Corporate surplus, generally referred to by accountants as Retained Earnings, forms the basis for various distributions to shareholders of a corporation. This happens most commonly through the cash dividends that are paid by most Canadian companies. Less commonly, we encounter stock dividends and dividends in kind (distributions of corporate assets other than cash).

14-97. These fairly routine types of dividends were given coverage in Chapter 7 in our material on property income. However, they will be reviewed at this point as an introduction to the various types of deemed dividends that are under consideration here. We will also give further attention to ITA 83(2) capital dividends.

14-98. In addition to these various types of actual dividends, several types of deemed dividends can occur. The specific types of deemed dividends that will be covered in this section of Chapter 14 are as follows:

- ITA 84(1) Deemed Dividend on Increase of PUC
- ITA 84(2) Deemed Dividend on Winding Up or Reorganization of a Business
- ITA 84(3) Deemed Dividend on Redemption, Acquisition, or Cancellation of Shares
- ITA 84(4) and (4.1) Deemed Dividend on Reduction of PUC

14-99. With the exception of capital dividends, all of the dividends considered here are subject to taxes when they are actually received or deemed to be received by an individual. This means that, provided they are received from a taxable Canadian corporation, they will generally be subject to the dividend gross up and tax credit procedures. In those situations where they are designated as such by the payor, they will be treated as eligible dividends.

14-100. When such dividends are received by a corporation, rather than by an individual, there will be no gross up of the amount, nor any credit against corporate tax payable. The recipient corporation will include only the amount received in their Net Income For Tax Purposes. Further, this amount will generally be deducted in the determination of Taxable Income.

## Regular Cash Dividends

14-101. Regular cash dividends are paid out of a corporation's unrestricted surplus balances. The payment of cash dividends serves to reduce these balances. Unlike the payment of interest on debt, the payment of cash dividends does not create a tax deduction for the corporation. In effect, they are paid out of after tax funds.

14-102. If cash dividends are received by an individual or a trust, they are subject to the usual gross up and tax credit procedures. In contrast, if they are paid to another corporation, they are included in the corporation's Net Income For Tax Purposes, but deducted in the determination of the corporation's Taxable Income.

14-103. A further point here relates to the accounting treatment of dividends on certain types of preferred shares. IAS 32, *Financial Instruments - Presentation*, recommends that shares which require mandatory redemption by the issuer be classified as liabilities. Consistent with this, the dividend payments on these shares must be disclosed as interest, resulting in the amount of the distribution being deducted in the determination of accounting net income.

14-104. To date, this treatment has not been recognized by the CRA. From a tax point of view, the dividends paid on preferred shares with mandatory redemption provisions will be given the same treatment as any other dividend. This means that, even if the GAAP based financial statements of the enterprise present preferred dividends as interest expense, they will not be deductible to the paying corporation. This difference will require adjustment in converting accounting income to a corporation's Net Income For Tax Purposes.

## Stock Dividends

14-105. From an accounting perspective, a stock dividend is a pro rata distribution of new shares to the existing shareholder group of the corporation, normally accompanied by a capitalization of Retained Earnings equal to the fair market value of the shares issued.

**EXAMPLE** Jessica Rabin owns 100 shares of Fergis Ltd. She acquired these shares several years ago for $2,500 ($25 per share). On January 1, 2019, the Shareholders' Equity of Fergis Ltd. is as follows:

| | |
|---|---|
| No Par Common Stock (1,000,000 Shares) | $ 7,500,000 |
| Retained Earnings | 12,500,000 |
| Total Shareholders' Equity | $20,000,000 |

On December 31, 2019, the publicly traded shares of Fergis have a fair market value of $30 per share. On this date, the Company declares a 10 percent stock dividend (100,000 shares). This dividend is not designated as eligible.

**ANALYSIS - Fergis Ltd.** At the time of the stock dividend, Fergis would transfer an amount equal to the $3,000,000 [($30)(10%)(1,000,000)] fair market value of these shares from Retained Earnings to the contributed capital account. Subsequent to this transfer, the Shareholders' Equity of Fergis would be as follows:

| | |
|---|---|
| No Par Common Stock (1,100,000 Shares) | $10,500,000 |
| Retained Earnings ($12,500,000 - $3,000,000) | 9,500,000 |
| Total Shareholders' Equity | $20,000,000 |

From a tax point of view, the $3,000,000 increase in contributed capital would generally be an increase in PUC, reflecting an increase in the amount that could be distributed to the shareholders of the company on a tax free basis.

**ANALYSIS - Jessica Rabin** As a result of the stock dividend, she will receive 10 shares [(10%)(100)] of stock worth $300 [(10)($30)]. This dividend will be taxable to the extent that it reflects an increase in PUC. Provided the increase in the Fergis Ltd. PUC is equal to the $3,000,000 increase in Contributed Capital (the usual case), Jessica will have a dividend of $300 [($3,000,000)(100 ÷ 1,000,000)]. This non-eligible dividend will be grossed up to a taxable amount of $345 [($300)(115%)].

With respect to the adjusted cost base of the new shares, ITA 52(3) will deem her to have acquired 10 additional shares at a cost of $300. With this addition, the average per share adjusted cost base would be $25.45 [($2,500 + $300) ÷ 110].

**Note On PUC** In most accounting and tax texts, the usual procedure is to transfer an amount equal to the fair market value of the dividend shares issued to Retained Earnings. However, this may not be the case. In some provinces, the amount of legal stated capital to be assigned to the dividend shares is discretionary. If the assigned amount is a value that is lower than fair market value, the corresponding transfer to PUC will be lower. This results in a lower taxable value for the stock dividend and a smaller addition to the adjusted cost base of the shares.

14-106. These stock dividend rules create an unfortunate situation for the taxpayer. An individual receiving stock dividends will require a cash outflow (taxes on the dividend received) with no corresponding cash inflows (the dividends are not received in cash). This approach to the taxation of stock dividends serves to significantly discourage their use in Canada, particularly in the case of large publicly traded companies.

14-107. As noted, however, it is possible for a company to issue shares with a legal stated capital and a PUC that is less than fair market value. When this is the case, the negative tax effect that was described in the preceding paragraph can be reduced.

## Exercise Fourteen - 10

**Subject:** Stock Dividends

On June 30, 2019, the Shareholders' Equity of Sturgis Inc. is as follows:

| | |
|---|---|
| Common Stock (23,400 Shares Outstanding) | $351,000 |
| Retained Earnings | 462,000 |
| Total Shareholders' Equity | $813,000 |

On this date, the Company declares a 5 percent stock dividend. This dividend is not designated as eligible. At this time, the shares are trading at $25 per share. The Company increases its PUC by the fair market value of the new shares issued.

Jean Tessier is holding 1,000 of the Sturgis shares which he acquired several years ago at a cost of $18 per share. Determine the effect of this transaction on Jean's 2019 Net Income For Tax Purposes and 2019 federal Tax Payable. In addition, determine the adjusted cost base per share of his Sturgis Inc. holding.

**SOLUTION available in print and online Study Guide.**

## Dividends In Kind

14-108. While somewhat unusual, corporations do sometimes declare dividends that are payable in assets other than cash, or the corporation's own shares. An example of this might be a situation in which a corporation has a major holding of another corporation's shares and wishes to dispose of them. If the block is large, sale on the open market could significantly depress the proceeds received. A possible alternative is to distribute the shares on a pro rata basis to the corporation's existing shareholders.

14-109. From the point of view of the corporation, the dividend is treated as a disposition of the distributed property. Under ITA 52(2), the proceeds of disposition will be deemed to be the fair market value of the property distributed. Depending on the type of property, this could result in a capital gain, capital loss, recapture or terminal loss for the corporation.

14-110. Also under ITA 52(2), the shareholders are deemed to have acquired the assets at their fair market value. This amount is considered to be a taxable dividend subject to the usual gross up and tax credit procedures for eligible and non-eligible dividends.

**EXAMPLE** Hold Ltd. owns shares in Bold Inc. These shares have an adjusted cost base of $800,000 and a fair market value of $3,500,000. Hold Ltd. decides to distribute the Bold Inc. shares as a dividend in kind to its shareholders, all of whom are individuals.

**ANALYSIS** The tax consequences of this dividend are as follows:

- Based on deemed proceeds of $3,500,000, Hold Ltd. will have a taxable capital gain of $1,350,000 [(1/2)($3,500,000 - $800,000)].
- Hold Ltd. will have declared a dividend of $3,500,000.
- The shareholders will have received a taxable dividend of $3,500,000, subject to either the eligible or non-eligible dividend gross up and tax credit procedures.
- The adjusted cost base of the Bold Inc. shares to the Hold Ltd. shareholders will be $3,500,000.

## Exercise Fourteen - 11

**Subject:** Dividends In Kind

Sandrine Cloutier owns 15 percent of the 500,000 outstanding shares of Cloutier Ltd. Cloutier Ltd. owns 150,000 shares of Botan Inc. The Botan Inc. shares were acquired at a cost of $42 per share and have a current fair market value of $51 per share. On June 30, 2019, Cloutier Ltd. declares a non-eligible dividend involving the distribution of all of the Botan shares on a pro rata basis to its existing shareholders.

Determine the effect of the payment of this dividend on Cloutier Ltd.'s 2019 Net Income For Tax Purposes. In addition, determine the effect of the payment of this dividend on Sandrine Cloutier's 2019 Net Income For Tax Purposes and 2019 federal Tax Payable.

**SOLUTION available in print and online Study Guide.**

## Capital Dividends Under ITA 83(2)

14-111. As we have previously indicated, the balance in the capital dividend account reflects amounts that can be distributed on a tax free basis to the shareholders of the private corporation. However, this tax free status does not happen automatically. When a corporation makes a distribution, an amount not in excess of the balance in the capital dividend account can be designated as a capital dividend. This is accomplished through an election under ITA 83(2), using Form T2054. Note that, provided there is a balance in the capital dividend account, this election can be made both for regular and for deemed dividends.

14-112. Distributing a capital dividend reduces the balance in the capital dividend account. It will be received by the taxpayer, whether the taxpayer is a corporation, a trust or an individual, on a tax free basis with no reduction in the adjusted cost base of their shares. You will also recall that, if the recipient of the capital dividend is a private corporation, the amount of the dividend will be added to the recipient corporation's capital dividend account.

14-113. If an election is made to pay a capital dividend in excess of the balance in the capital dividend account, a tax equal to 60 percent of the excess will be assessed under ITA 184(2) of the *Income Tax Act*. This will not affect the tax free nature of the dividend to the recipient.

14-114. In some circumstances, an excess election can occur inadvertently. For example, the non-taxable portion of a capital gain may be added to the capital dividend account and, at a subsequent point in time, a reassessment will cause the capital gain to be recharacterized as business, rather than capital. This in turn means that the capital dividend account will be reduced through the reassessment process. If this happens, ITA 184(3) and 184(4) contain provisions that allow for a revision of the election in order to avoid the 60 percent penalty.

14-115. As a final point, the fact that capital dividends are not taxable dividends means that they are not subject to the dividend gross up and tax credit procedures. In turn, this means that they cannot be classified as either eligible or non-eligible dividends under any circumstances.

## Deemed Dividends Under ITA 84(1) - Increase In PUC

### General Rules

14-116. ITA 84(1) dividends involve a situation where there has been an increase in the corporation's PUC, accompanied by a smaller increase in the net assets of the corporation. This would include situations where the increase in PUC is accompanied by no increase in the net assets of the corporation.

14-117. The most common example of this type of deemed dividend would involve situations where a corporation issues shares to settle a debt obligation that has a carrying value that is smaller than the fair market value of the shares.

**EXAMPLE** A corporation issues shares with a PUC of $500,000 to a creditor, in settlement of debt with a carrying value of $450,000. Because of a decline in interest rates since the debt was issued, the $500,000 reflects the market value of the debt.

**ANALYSIS** This transaction would result in an ITA 84(1) deemed dividend of $50,000 ($500,000 - $450,000).

14-118. The reason for treating this $50,000 as a form of income to the shareholders is that it represents an increase in the amount that can be distributed to them on a tax free basis. As a group, their economic position has clearly been improved as a result of this transaction.

14-119. It is important to note that, because the extra $50,000 in PUC will be allocated to all of the shareholders of the particular class, a corresponding treatment will be given to the deemed dividend. That is, the $50,000 dividend will be allocated on a pro rata basis to all of the shareholders of the class, not just the new shareholder who acquired his shares by giving up $450,000 in debt securities.

14-120. In order to provide equity in this situation, the amount assessed as a dividend will be added to the adjusted cost base of the shares. For the new shareholder, his share of the $50,000 ITA 84(1) deemed dividend is added to the adjusted cost base of the shares that were issued to him, resulting in an adjusted cost base for these shares of $450,000 plus his share of the deemed dividend. Note that this will not be the PUC of these shares, since PUC is calculated as an average value for all of the outstanding shares on a class by class basis.

**EXAMPLE** Lantin Inc. has 250,000 shares outstanding at the beginning of the current year. These shares were sold for $12 each, resulting in a PUC of $3,000,000. Jeanne Moreau owns 25,000 of these shares which she acquired at the time of their issue for $12 each.

During the current year, the company issues 50,000 new shares with a market value of $750,000 ($15 per share) in order to retire debt with a carrying value of $675,000.

Shortly after the 50,000 new shares were issued, Ms. Moreau sells her 25,000 shares for $450,000 ($18 per share).

**ANALYSIS** The ITA 84(1) deemed dividend will be calculated as follows:

| | |
|---|---|
| PUC Of New Shares [(50,000)($15)] | $750,000 |
| Increase In Net Assets (Carrying Value Of Debt Retired) | ( 675,000) |
| ITA 84(1) Deemed Dividend | $ 75,000 |

This would be allocated to all of the outstanding shares in the amount of $0.25 ($75,000 ÷ 300,000) per share. This would be a taxable dividend, subject to either the eligible or non-eligible dividend gross up and tax credit procedures.

With respect to Ms. Moreau's holding, this $0.25 per share dividend would increase her per share adjusted cost base to $12.25 ($12.00 + $0.25). Given this, the tax consequences of her sale would be calculated as follows:

| | |
|---|---|
| Proceeds Of Disposition [(25,000)($18)] | $450,000 |
| Adjusted Cost Base [(25,000)($12.25)] | ( 306,250) |
| Capital Gain | $143,750 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain | $ 71,875 |

## Exercise Fourteen - 12

**Subject:** ITA 84(1) Deemed Dividends

At the beginning of the current year, Unilev Inc. has 126,000 shares of common stock outstanding. The shares were originally issued at $10.50 per share for total proceeds of $1,323,000, with this amount constituting the PUC. During the current year, a creditor holding $450,000 of the Company's debt agrees to accept 40,000 newly issued common shares of the Company in exchange for settlement of the debt obligation. At the time of this exchange, the shares are trading at $12.70 per share.

Subsequent to the exchange, Mr. Uni, who had purchased 5,000 Unilev Inc. shares at the time of their original issue, sells the shares for $13.42 per share.

Describe the tax consequence(s) to all of the shareholders of Unilev Inc. as a result of the exchange of debt for common shares. In addition, describe the tax consequences to Mr. Uni resulting from the sale of his Unilev Inc. shares.

**SOLUTION available in print and online Study Guide.**

### *Excluded Transactions*

14-121. There are a number of transactions involving increases in PUC that are specifically excluded from the ITA 84(1) deemed dividend treatment. The most important of these are:

- **Stock Dividends** While there will be an increase in PUC in excess of the increase in net assets when a stock dividend is declared, such dividends are not considered to be an ITA 84(1) deemed dividend. Rather, they are taxed under ITA 82(1) as regular dividends. From the point of view of the recipient of the dividend, this distinction is of no consequence.
- **Shifts Between Classes** When the PUC of one class of shares is decreased and, at the same time, the PUC of a different class is increased by a corresponding amount, there is no ITA 84(1) deemed dividend.
- **Conversion Of Contributed Surplus** In situations where the consideration received for shares issued is in excess of the amount added to PUC, for tax purposes a contributed surplus balance is created. This contributed surplus balance can generally be converted to PUC, without the increase in PUC being treated as a deemed dividend under ITA 84(1).

## Deemed Dividends Under ITA 84(2) - On Winding-Up

14-122. When there is a winding-up of a Canadian corporation under the provisions of ITA 88(2), the corporate assets will be sold and the liabilities, including taxes on the various types of income created by the sale of the assets, will be paid. The remaining cash will then be distributed to the shareholders of the corporation. Subsequent to this distribution, the shares of the corporation will be canceled. This process is covered in detail in Chapter 17.

14-123. In this Chapter, we would note that ITA 84(2) indicates that the excess of the fair market value of the amount distributed over the PUC of the shares that are canceled is considered to be a deemed dividend. While ITA 84(2) defines this entire amount as a deemed dividend, some components of this total are, in effect, redefined under ITA 88(2)(b). Specifically, ITA 88(2)(b) indicates that the ITA 84(2) dividend will be dealt with as follows:

**Capital Dividend** To the extent that the corporation has a balance in its capital dividend account, ITA 88(2)(b) indicates that this amount of the distribution will be considered a separate dividend, which will be received on a tax free basis under ITA 83(2). As was noted in our discussion of capital dividends, this treatment will only apply if an appropriate election is made.

**Distribution Of Pre-1972 Capital Surplus On Hand** As mentioned previously in this Chapter, the importance of Pre-1972 Capital Surplus On Hand has diminished greatly over time and is no longer of importance to most users of a general text such as this. However we would point out here that if the corporation has pre-1972 Capital Surplus On Hand, the distribution of this amount will be deemed not to be a dividend.

**Taxable Dividend** Any remaining distribution will be treated as a taxable dividend under ITA 84(2), subject to either the eligible or non-eligible dividend gross up and tax credit procedures.

14-124. To illustrate these provisions, consider the following:

**EXAMPLE** After selling its assets and paying all of its liabilities, a corporation has cash of $1,200,000 available for distribution to its only shareholder. The PUC of the company's shares is $100,000 and this is also their adjusted cost base. The balance in the capital dividend account is $175,000. The company makes the appropriate election to have the distribution of the $175,000 treated as a capital dividend under ITA 83(2).

**ANALYSIS** The analysis of the $1,200,000 distribution would be as follows:

| | |
|---|---|
| Cash Distributed | $1,200,000 |
| PUC Of Shares | ( 100,000) |
| ITA 84(2) Deemed Dividend | $1,100,000 |
| ITA 83(2) Capital Dividend | ( 175,000) |
| ITA 88(2)(b) Taxable Dividend | $ 925,000 |

Depending on whether or not the $925,000 wind-up dividend, or some portion of it, is designated as eligible, it would be subject to either the eligible or non-eligible dividend gross up and tax credit procedures.

14-125. From the point of view of the shareholder, there has been a disposition of his shares, an event that requires the determination of a capital gain or loss. In the absence of a mitigating provision, this capital gain or loss would be calculated using the $1,200,000 as the proceeds of disposition, an approach that would double count $1,100,000 of this amount as both a deemed dividend and a capital gain or loss.

14-126. Fortunately, this problem is resolved by the ITA 54 definition of "proceeds of disposition". This definition indicates that, to the extent that an amount received is considered to be a deemed dividend under ITA 84(2), it is excluded from the proceeds of disposition. This means that the capital gain on the disposition of the shares in the example would be calculated as follows:

| | |
|---|---|
| Cash Distributed | $1,200,000 |
| Less: ITA 84(2) Deemed Dividend | ( 1,100,000) |
| ITA 54 Proceeds Of Disposition | $ 100,000 |
| Adjusted Cost Base | ( 100,000) |
| Capital Gain | Nil |

## Exercise Fourteen - 13

**Subject:** ITA 84(2) Deemed Dividends

After selling its assets and paying all of its liabilities, a corporation has cash of $2,350,000 available for distribution to its only shareholder. The corporation was established 20 years ago with an investment of $250,000. This figure is both the PUC and the adjusted cost base of the shares. The balance in the capital dividend account is $340,000 and the company makes the appropriate election to have the distribution

of this amount be treated as a capital dividend under ITA 83(2). What are the tax consequences of distributing the $2,350,000 to the corporation's only shareholder?

**SOLUTION available in print and online Study Guide.**

## Deemed Dividends Under ITA 84(3) - On Redemption, Acquisition, Or Cancellation Of Shares

14-127. An ITA 84(3) deemed dividend occurs most commonly when a corporation redeems some of its outstanding shares. Such dividends can also occur when the corporation acquires or cancels some of its outstanding shares. To the extent that the redemption amount paid by the corporation exceeds the PUC of the shares redeemed, a deemed dividend is assessed under ITA 84(3).

14-128. For the corporation, this is a distribution of their unrestricted surplus balance. From the point of view of the person receiving the redemption proceeds, the deemed dividend component of the proceeds will be treated as an ordinary taxable dividend, subject to either the eligible or non-eligible dividend gross up and tax credit procedures.

14-129. However, there is a problem here. As a redemption of shares is also a disposition of the redeemed shares, the proceeds of redemption will also be used as the proceeds of disposition. As was the case with the ITA 84(2) deemed dividends on winding up, this creates the possibility that some amount of the proceeds will be double counted as both a deemed dividend and a capital gain.

14-130. The solution to this problem is similar to the one we described in our discussion of ITA 84(2) deemed dividends. The ITA 54 definition of proceeds of disposition excludes any amounts received that are deemed to be ITA 84(3) dividends.

**EXAMPLE** Mr. Jonas owns all of the preferred shares of Jonas Ltd. They were issued with a PUC of $75,000. However, their adjusted cost base to Mr. Jonas is $25,000. They are redeemed by the corporation for $200,000.

**ANALYSIS** The analysis of this transaction is as follows:

| | |
|---|---|
| Cash Distributed | $200,000 |
| PUC Of Shares Redeemed | ( 75,000) |
| ITA 84(3) Deemed Dividend | $125,000 |

This deemed dividend would be subject to either the eligible or non-eligible dividend gross up and tax credit procedures.

The capital gain on the disposition would be calculated as follows:

| | |
|---|---|
| Proceeds Of Redemption | $200,000 |
| Less: ITA 84(3) Deemed Dividend | ( 125,000) |
| ITA 54 Proceeds Of Disposition | $ 75,000 |
| Adjusted Cost Base | ( 25,000) |
| Capital Gain (PUC - ACB) | $ 50,000 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain | $ 25,000 |

We would note that, in situations where the PUC and adjusted cost base are equal, these calculations will result in no capital gain or loss. If the PUC exceeds the adjusted cost base, the result will be a capital gain. Alternatively, if the PUC is less than the adjusted cost base, a capital loss will result from the disposition. Note that, if the individual shareholder receiving redemption proceeds is affiliated with the corporation, any capital loss arising on the disposition will be disallowed.

## Exercise Fourteen - 14

**Subject:** ITA 84(3) Deemed Dividends

When first incorporated, Tandy Ltd. issued 233,000 common shares in return for $1,922,250 in cash ($8.25 per share). All of the shares were issued to Ms. Jessy Tandy, the founder of the Company. Except for 15,000 shares, she is still holding all of the originally issued shares. The 15,000 shares were sold to Ms. Tandy's brother, Jesuiah, for $7.90 per share, the estimated market value of the shares at that time. Because of ongoing difficulties between the two siblings, Ms. Tandy has arranged for Tandy Ltd. to redeem all of her brother's shares at a price of $11.75 per share during the current year. Any dividends resulting from the redemption will be non-eligible. Determine the tax consequences of this redemption to Ms. Tandy and Jesuiah.

**SOLUTION available in print and online Study Guide.**

## Deemed Dividends Under ITA 84(4) And ITA 84(4.1)

14-131. This type of dividend is not as common as the other deemed dividends we have discussed. It arises when a corporation resident in Canada distributes a part of its invested capital to its shareholders, without redeeming or canceling any of its shares. It might occur, for example, if a corporation divested itself of a major division and did not wish to reinvest the proceeds from the sale in other corporate assets. In this type of situation, the proceeds may be distributed to shareholders. Such distributions are commonly referred to as liquidating dividends.

14-132. In order to make all, or part, of the distribution tax free, it is usually accompanied by a reduction in PUC. For a non-public company, if the reduction in PUC is equal to the amount distributed, no ITA 84(1) dividend arises. However, if the distribution exceeds the PUC reduction, an ITA 84(4) deemed dividend is created. Note that ITA 84(4.1) contains a different set of rules for public companies. Under these alternative rules, a deemed dividend can arise, even if the distribution does not exceed the PUC reduction.

**EXAMPLE** Jong Ltd., a CCPC, has shares with a PUC of $5,000,000 and a nil balance in its capital dividend account. As it has disposed of a major division for cash, it will distribute $1,000,000 to its shareholders. In order to limit the tax effects of this distribution, the PUC of the shares will be reduced by $700,000.

**ANALYSIS** Under ITA 84(4), $700,000 of the total distribution will be a tax free distribution of PUC. The remaining $300,000 is treated as a deemed dividend, subject to the usual gross up and tax credit procedures. The adjusted cost base of the shares would be reduced by $700,000, the amount of the tax free distribution to shareholders. However, there would be no reduction in the adjusted cost base for the $300,000 distribution as it would be subject to tax as a deemed dividend.

14-133. ITA 84(4.1) provides a different rule that overrides ITA 84(4) in the case of public companies. For these companies, if a payment is made to shareholders in conjunction with a reduction of PUC that is not part of a reorganization of the corporation's business or its capital, and there is no redemption, acquisition, or cancellation of shares, the entire distribution is generally treated as a deemed dividend. Note that ITA 84(3) would be applicable if there was a redemption, acquisition, or cancellation of shares.

14-134. With respect to our example, this means that, if Jong Ltd. is a public company, the entire $1,000,000 distribution will be considered to be a deemed dividend under ITA 84(4.1). As the $1,000,000 amount will be subject to tax, the adjusted cost base of the shares will not be reduced by this distribution.

14-135. There is an exception to this general rule for public corporations. If the payment can reasonably be considered to be derived from a transaction that is outside the ordinary

course of business for the corporation, it can be considered a tax free return of capital to the extent that it is accompanied by a PUC reduction.

14-136. An example of this would be where the company disposes of a business unit of the corporation and does not wish to reinvest the proceeds in some other line of business activity. The distribution would have to be made within 24 months of the occurrence of the non-ordinary transaction and the exception would only apply to the first such payment made. If there is more than one payment, the second and any subsequent payments would come under the general ITA 84(4.1) deemed dividend rule.

**Exercise Fourteen - 15**

**Subject**: ITA 84(4) Deemed Dividends

Mr. Jondo owns all of the outstanding shares of Jondo Ltd., a CCPC. The shares have a PUC of $450,000 and an adjusted cost base of $625,000. Because it has recently consolidated its operations, Jondo Ltd. pays a liquidating dividend of $330,000, accompanied by a PUC reduction of $225,000. What are the tax consequences of this distribution to Mr. Jondo?

**SOLUTION available in print and online Study Guide.**

**We suggest you work Self Study Problem Fourteen-8 at this point.**

**Additional Supplementary Self Study Problems Are Available Online.**

## Key Terms Used In This Chapter

14-137. The following is a list of the key terms used in this Chapter. These terms, and their meanings, are compiled in the Glossary located at the back of the Study Guide.

Acquisition Of Control
Annual Business Limit
Apprenticeship Job Creation Tax Credit
Associated Corporations
Capital Dividend
Capital Dividend Account
CCPC
Common Shares
Contributed Capital
Control [ITA 256(1.2)(c)]
Corporation
Deemed Dividends
Deemed Disposition
Dividends
Dividends In Kind
Earned Capital
Earned Surplus
Group Of Persons
Investment Tax Credit
Liquidating Dividend
Paid Up Capital
Preferred Shares
PUC
Qualified Property
Qualifying Corporation
Redemption Of Shares
Refundable Investment Tax Credit
Related Persons
Retained Earnings
Scientific Research And Experimental Development (SR&ED)
Shareholders' Equity
Specified Class ITA 256(1.1)
Specified Shareholder ITA 248(1)
Stock Dividend
Taxable Capital Employed In Canada
Winding-Up Of A Canadian Corporation

## References

14-138. For more detailed study of the material in this Chapter, we refer you to the following:

| | |
|---|---|
| ITA 52(2) | Cost Of Property Received As Dividend In Kind |
| ITA 52(3) | Cost Of Stock Dividends |
| ITA 82(1) | Taxable Dividends Received |
| ITA 83(2) | Capital Dividend |
| ITA 84 | Deemed Dividend |
| ITA 88(2) | Winding Up Of A Canadian Corporation |
| ITA 127(5) to 127.1(4) | Investment Tax Credits |
| ITA 249(4) | Year End On Change In Control |
| ITA 251 | Arm's Length |
| ITA 256 | Associated Corporations |
| ITR 4600 | Investment Tax Credit - Qualified Property |
| ITR 4601 | Investment Tax Credit - Qualified Transportation Equipment |
| ITR 4602 | Certified Property |
| IC 78-4R3 | Investment Tax Credit Rates |
| S1-F5-C1 | Related Persons And Dealing At Arm's Length |
| S3-F2-C1 | Capital Dividends |
| IT-64R4 | Corporations: Association And Control (Consolidated) |
| IT-149R4 | Winding Up Dividend |
| IT-302R3 | Losses Of A Corporation |
| IT-463R2 | Paid-Up Capital |

# Problems For Self Study (Online)

To provide practice in problem solving, there are Self Study and Supplementary Self Study problems available on MyLab Accounting.

Within the text we have provided an indication of when it would be appropriate to work each Self Study problem. The detailed solutions for Self Study problems can be found in the print and online Study Guide.

We provide the Supplementary Self Study problems for those who would like additional practice in problem solving. The detailed solutions for the Supplementary Self Study problems are available online, not in the Study Guide.

The .PDF file "Self Study Problems for Volume 2" on MyLab contains the following for Chapter 14:

- 8 Self Study problems,
- 5 Supplementary Self Study problems, and
- detailed solutions for the Supplementary Self Study problems.

# Assignment Problems

(The solutions for these problems are only available in the solutions manual that has been provided to your instructor.)

### Assignment Problem Fourteen - 1

**(Acquisition Of Control Rules - Losses)**

For many years, Janice Virtue had been a professor of Business Ethics in the Faculty of Business at a major Canadian university. In 2017, while continuing to teach one section of Business Ethics, she established Virtue Ltd. (VL) in order to market her numerous publications and online courses involving the application of ethical principles to business situations.

While the company experienced a net operating loss of $128,000 in the fiscal period ending December 31, 2017, VL experienced rapidly increasing sales during 2018. Because Janice believed the improvement was indicative of the success to come, VL moved to larger premises which were purchased for $423,000. Of this total, $100,000 related to the land, with the remaining $323,000 allocated to the building. Because the building was to be used exclusively for non-residential purposes, it was allocated to a separate Class 1. In selling the previous premises in 2018, VL experienced an allowable capital loss on the land of $36,000. The building was sold at its UCC value.

The Net Income For Tax Purposes of VL for the year ending December 31, 2018, after deducting CCA on the Class 1 building, was $16,000. VL realized no capital gains during the year.

In early 2019, a joint CRA/RCMP operation found that Janice was the mastermind and guiding force behind a network of illegal aliens working throughout Canada. They were selling stolen weapons and preparing thousands of tax returns with large fictitious charitable donations. The fee for the tax return preparation was always paid for in cash which was not reported to the CRA.

Various charges were laid and, while Janice remains free on bail, a court date has been set for September.

By May, 2019, Janice's lawyer indicated that it is likely that she will be convicted on multiple charges and will spend a significant amount of time in prison. She has also been advised by her employer that her contract to teach Business Ethics will not be renewed in the fall.

Given these circumstances, Janice decides to sell her VL shares. She finds a corporate buyer who is willing to acquire the shares on June 1, 2019. This buyer, Peerzon Books, is a large publicly traded Canadian company. The VL assets include the copyrights to all of her publications. While sales of these publications have fallen off precipitously in 2019, Peerzon believes its crack marketing team will be able to put the proper spin on Janice's life experiences and sales will take off.

As this acquisition of control resulted in a deemed year end, VL prepared an Income Statement for the period January 1, 2019 through May 31, 2019. This short fiscal period statement showed an additional business loss of $34,000 for this period. There were, however, no further capital losses.

On May 31, 2019, the values of the Company's assets were as follows:

| Asset | Cost | UCC | Fair Market Value |
|---|---|---|---|
| Temporary Investments | $ 32,000 | N/A | $ 7,000 |
| Accounts Receivable | 123,000 | N/A | 110,000 |
| Land | 100,000 | N/A | 115,000 |
| Building | 323,000 | $313,310 | 352,000 |
| Equipment | 46,000 | 33,120 | 5,000 |
| Vehicles (Class 10) | 36,000 | 21,420 | 25,000 |
| Copyrights | Nil | Nil | 42,000 |

VL will make all possible elections to minimize any net capital and non-capital loss balances.

Shortly after taking over VL, Peerzon Books decided that some of the extra space in VL's facilities could be used for manufacturing electronic reading devices. VL's income (loss) from the two separate businesses for the period June 1 through December 31, 2019, and for the 2020 taxation year was as follows:

| Business | June 1 to Dec. 31, 2019 | 2020 Year |
|---|---|---|
| Electronic Reading Devices | $123,000 | ($ 26,000) |
| Janice's Publications | ( 53,000) | 185,000 |

**Required:**

A. Determine the amount of the non-capital loss balance that will be carried forward after the acquisition of control by Peerzon Books, and calculate the amount of the net capital losses that will be lost as a result of this change in ownership, if any.

B. Indicate the maximum amount of the non-capital loss carry forward that can be used during the period June 1 through December 31, 2019, and the amount remaining at December 31, 2019.

C. Indicate the maximum amount of the non-capital loss carry forward that can be used during 2020, and the amount remaining at December 31, 2020.

### Assignment Problem Fourteen - 2

***(Acquisition Of Control Rules)***

Boudin Inc. was incorporated 10 years ago in New Brunswick. At its formation, all of the shares were issued to Andre Boudin. The Company's business involved the distribution of health food products throughout the Maritime provinces. The Company's taxation year ends on December 31.

The Company operated successfully for a number of years. However, late in 2016, a local newspaper found that many of the claims made by the products that they distributed were either misleading or false. Widespread publication of this information resulted in a steep decline in the sales of Boudin Inc.

Because of this the Company had an operating loss of $42,000 in 2017 and $123,000 in 2018. In addition, there was a 2018 allowable capital loss of $32,000 on the disposal of some temporary investments.

In early 2019, seeing no real hope for a return to profitable operations, Mr. Boudin begins a search for a buyer for his Company's shares. On May 1, 2019, all of the shares are sold to Healthy Bites Ltd., a manufacturer of health food products. This Company hopes to be able to revive the fortunes of Boudin Inc.

For the period January 1, 2019 through April 30, 2019, Boudin Inc. experienced a business loss of $48,000. This figure includes a write-down of inventories to their fair market values on April 30, 2019, and a deduction for uncollectible receivables, calculated as per the provisions of ITA 111(5.3). It does not include any taxable capital gains, allowable capital losses, Allowable Business Investment Losses, or property losses.

On April 30, 2019, Boudin Inc.'s assets had the following values:

| Asset | Cost | UCC | Fair Market Value |
|---|---|---|---|
| Long-Term Investments* | $ 47,000 | N/A | $ 82,000 |
| Land | 207,000 | N/A | 305,000 |
| Building | 465,000 | $360,000 | 485,000 |
| Equipment | 350,000 | 190,000 | 150,000 |

*Healthy Bites intends to sell these investments as soon as possible.

**Required:**

A. Indicate the amount of any non-capital and net capital loss carry forwards that would remain after the May 1, 2019 acquisition of control, using the assumption that Healthy Bites Ltd. elects to have a deemed disposition of all eligible assets at their fair market values.

B. If Healthy Bites Ltd. decides to only use the election(s) required to eliminate those losses that would expire at the acquisition of control, indicate the assets on which the elections should be made, and the amounts that should be elected.

C. Advise Healthy Bits Ltd. as to which course of action (Part A or B) they should take.

### *Assignment Problem Fourteen - 3*

***(Associated Companies)***

The following situations are **independent** of each other. All of the corporations involved are Canadian controlled private corporations and have only one class of shares.

A. Barton Ltd. owns 51 percent of the shares of Norton Inc.

B. Thomas Boulding owns 60 percent of the shares of Boulding Ltd. and 70 percent of the shares of Boulding Inc.

C. Mary Cunningham and Brenda Parton each own 50 percent of the shares of Elm Ltd. In addition, they each own 50 percent of the shares of Maple Inc. Mary and Brenda are not related.

D. Alice Fielding owns 100 percent of the shares of Fielding Inc. and 40 percent of the shares of Lawson Ltd. Betty Falcon owns 100 percent of the shares of Falcon Inc. and 40 percent of the shares of Lawson Ltd. Alice is the sister of Betty's husband. The remaining 20 percent of the shares of Lawson Ltd. are owned by unrelated parties.

E. Michael Forbes owns 70 percent of the shares of Forbes Ltd. and 30 percent of the shares of Malcom Inc. Forbes Ltd. also owns 30 percent of the shares of Malcom Inc.

F. Richard Barnes, Susan Firth, and Terry Anson each own one-third of the shares of Rastau Ltd. In addition, Richard and Susan each own 50 percent of the shares of Sucrol Inc.

**Required:** For each of the preceding situations, indicate whether the corporations are associated and explain your conclusion with reference to the *Income Tax Act*. In order to assist you in answering this question, we have provided you with the content of ITA 256(1).

**ITA 256(1) Associated corporations** — For the purposes of this Act, one corporation is associated with another in a taxation year if, at any time in the year,

(a) one of the corporations controlled, directly or indirectly in any manner whatever, the other;
(b) both of the corporations were controlled, directly or indirectly in any manner whatever, by the same person or group of persons;
(c) each of the corporations was controlled, directly or indirectly in any manner whatever, by a person and the person who so controlled one of the corporations was related to the person who so controlled the other, and either of those persons owned, in respect of each corporation, not less than 25% of the issued shares of any class, other than a specified class, of the capital stock thereof;
(d) one of the corporations was controlled, directly or indirectly in any manner whatever, by a person and that person was related to each member of a group of persons that so controlled the other corporation, and that person owned, in respect of the other corporation, not less than 25% of the issued shares of any class, other than a specified class, of the capital stock thereof; or
(e) each of the corporations was controlled, directly or indirectly in any manner whatever, by a related group and each of the members of one of the related groups was related to all of the members of the other related group, and one or more persons who were members of both related groups, either alone or together, owned, in respect of each corporation, not less than 25% of the issued shares of any class, other than a specified class, of the capital stock thereof.

## Assignment Problem Fourteen - 4

### *(Associated Companies)*

Each of the following is an **independent** Case involving the ownership of voting shares of Canadian controlled private corporations. All of the corporations have taxation years that end on December 31 and have only one class of shares.

A. Mr. Bond owns 55 percent of Sarnen Inc. Sarnen Inc. owns 40 percent of Barxo Ltd. Mr. Bond also owns 14 percent of Hax Ltd., which in turn owns 54 percent of the shares of Barxo Ltd. Mr. Bond's 10 year old daughter owns 6 percent of the shares of Barxo Ltd.

B. Mr. Jones, Mr. Knight, and Mr. Long are three unrelated individuals.

- Mr. Jones owns 50 percent of the shares of Anix Inc. and 25 percent of the shares of Brex Ltd.
- Mr. Knight owns 50 percent of the shares of Brex Ltd.
- Mr. Long owns 50 percent of the shares of Anix Inc. and 25 percent of the shares of Brex Ltd.

C. Sam Scully owns 60 percent of Scully Inc. His sister, Susan Wilson, owns 80 percent of Wilson Ltd. and 30 percent of Scully Inc. Sam Scully also owns 10 percent of Wilson Ltd.

D. Joan and Sarah Lartch are sisters. Joan owns 100 percent of the shares of JL Inc. and 31 percent of the shares of Meadow Ltd. Her sister Sarah owns 60 percent of the shares of SL Inc., with the remaining 40 percent of the shares held by her mother. Sarah also owns 39 percent of the shares of Meadow Ltd. The remaining shares of Meadow Ltd. are held by an unrelated party.

E. John and May Carp each own 30 percent of the shares of Jomay Inc. Serge and Beth Carp each own 45 percent of the shares of Besa Ltd. John and Serge Carp are brothers. Beth Carp owns 40 percent of the shares of Jomay Inc. and May Carp owns 10 percent of the shares of Besa Ltd.

**Required:** For each of the preceding Cases, determine whether the corporations are associated. Support your conclusions with references to specific provisions of ITA 256. In order to assist you in answering this question, we have provided you with the content of ITA 256(1).

**ITA 256(1) Associated corporations** — For the purposes of this Act, one corporation is associated with another in a taxation year if, at any time in the year,

(a) one of the corporations controlled, directly or indirectly in any manner whatever, the other;
(b) both of the corporations were controlled, directly or indirectly in any manner whatever, by the same person or group of persons;
(c) each of the corporations was controlled, directly or indirectly in any manner whatever, by a person and the person who so controlled one of the corporations was related to the person who so controlled the other, and either of those persons owned, in respect of each corporation, not less than 25% of the issued shares of any class, other than a specified class, of the capital stock thereof;
(d) one of the corporations was controlled, directly or indirectly in any manner whatever, by a person and that person was related to each member of a group of persons that so controlled the other corporation, and that person owned, in respect of the other corporation, not less than 25% of the issued shares of any class, other than a specified class, of the capital stock thereof; or

(e) each of the corporations was controlled, directly or indirectly in any manner whatever, by a related group and each of the members of one of the related groups was related to all of the members of the other related group, and one or more persons who were members of both related groups, either alone or together, owned, in respect of each corporation, not less than 25% of the issued shares of any class, other than a specified class, of the capital stock thereof.

### Assignment Problem Fourteen - 5

(Investment Tax Credits)
The following three independent cases involve the tax procedures associated with various types of investment tax credits.

#### Case A

In 2018, Baron Inc. employed 22 eligible apprentices. The total amount paid to these individuals is $458,000. Ten of the apprentices are paid $17,000 for the year, with the remaining twelve each being paid $24,000.

In addition, on December 15, 2018, the Company acquires $850,000 in Class 10 assets on which a 10 percent investment tax credit is available.

**Required:** Describe the 2018 and 2019 tax consequences associated with making these expenditures and claiming the related investment tax credits. Include in your solution the CCA for 2018 and 2019.

### Case B

Since its incorporation several years ago, Aria Inc. has been a Canadian controlled private corporation. Selected information for the taxation years 2018 and 2019 is as follows:

| | 2018 | 2019 |
|---|---|---|
| Taxable Income | $ 425,000 | $ 511,000 |
| Taxable Capital Employed In Canada | 10,800,000 | 11,200,000 |

**Required:** Determine Aria's SR&ED annual expenditure limit for the 2019 taxation year.

### Case C

Sylman Ltd. has qualified as a Canadian controlled private company since its incorporation. During 2018 it had Taxable Income of $17,000. The corresponding figure for 2019 is $4,000. The Company has no Tax Payable for the taxation year ending December 31, 2019, or for any of the three preceding years.

Despite its very low income figures, the Company has Taxable Capital Employed in Canada for 2018 of $14,700,000. The corresponding figure for 2019 is $14,482,000.

During 2019, the Company has made a number of expenditures that qualify for investment tax credits:

- $106,000 for qualified expenditures in the Atlantic Provinces.
- $2,700,000 in current expenditures for SR&ED.

**Required:** Determine the amount of the refund that Sylman Ltd. will receive as a result of earning these investment tax credits and any available carry forwards. Include in your answer any other tax consequences of these investment tax credits.

## Assignment Problem Fourteen - 6

### (Capital Dividend Account)

Since its incorporation in 2008, Park Inc. has qualified as a Canadian controlled private corporation. During the period since incorporation and until December 31, 2019, the Company has had the following transactions that might involve the capital dividend account.

1. In 2010, the Company sold a depreciable asset with a capital cost of $225,000. It was the last asset in its class and the balance in the Class at the time of the sale was $129,600. The proceeds from the sale were $275,000. No assets were added to the Class during 2010.
2. In 2012, the Company received a capital dividend of $46,000.
3. In 2013, the Company received life insurance proceeds, net of the adjusted cost base of the policy, in the amount of $27,500.
4. In 2014, the Company paid a capital dividend of $38,000 and eligible dividends of $19,000. The required election was made.
5. In 2014, the Company sold a parcel of land for $100,000. The adjusted cost base of this land was $145,000.
6. In January 2019, Park acquired all of the shares of a small incorporated business at a cost of $850,000. This total cost was allocated as follows:

| | |
|---|---|
| Non-Depreciable Assets | $150,000 |
| Depreciable Assets (See Note) | 500,000 |
| Goodwill | 200,000 |
| Total Cost | $850,000 |

**Note** The capital cost of the non-depreciable assets to the acquired business was $100,000. The capital cost of the depreciable assets was $450,000 and their UCC was $375,000. The goodwill was internally generated and was not reflected on the books of the acquired business. Park does not use a rollover provision to transfer the assets.

While Park intended to integrate this business into its other operations, they received an unsolicited offer to purchase the shares of this business for $965,000. Finding this offer too attractive to resist, it was accepted and the business was sold on October 1, 2019. On January 1, 2019, Park had no UCC balance in Class 14.1. The total proceeds were allocated as follows:

| | |
|---|---:|
| Non-Depreciable Assets | $175,000 |
| Depreciable Assets | 550,000 |
| Goodwill | 240,000 |
| Total Proceeds | $965,000 |

7. In 2019, the Company received a capital dividend of $17,800. They paid a capital dividend of $21,600 and eligible dividends of $8,000. The required election was made.

**Required:** Determine the balance in the Company's capital dividend account as of December 31, 2019.

## *Assignment Problem Fourteen - 7*
### *(Corporate Surplus Distributions)*

Groman Ltd. is a Canadian controlled private corporation whose shareholders are all individuals. On December 31 of the current year, the Company's condensed Balance Sheet is as follows:

| | | |
|---|---:|---:|
| Total Assets | | $62,000 |
| | | |
| Liabilities | | $22,000 |
| Shareholders' Equity: | | |
| 500 Preferred Shares (Paid Up Capital) | $11,000 | |
| 600 Common Shares (Paid Up Capital) | 15,600 | |
| Retained Earnings | 13,400 | 40,000 |
| Total Equities | | $62,000 |

Any dividends paid or deemed to be paid by Groman Ltd. would be non-eligible.

**Required:** Discuss the tax consequences of each of the following **independent** transactions. Tax consequences would include the increase or decrease in the individual shareholder's Taxable Income, any change in the adjusted cost base and/or PUC of any shares that are still in the hands of the individual shareholder after the described transaction(s), and any federal dividend tax credits that result from the described transaction(s).

A. (i) A long-term debtholder has agreed to convert $10,000 of his debt to 500 Preferred Shares, with a Paid Up Capital (PUC) of $11,000. This conversion does not qualify for the ITA 51 rollover that is described in Chapter 17 of the text.

(ii) After the conversion described in A(i), a different shareholder, with 250 Preferred Shares, sold them for $5,500 in an arm's length transaction. His shares cost $4,100 a number of years ago.

B. The Company declared and distributed a 5 percent stock dividend on the Common Shares. An addition of $780 was made to Paid Up Capital, with Retained Earnings reduced accordingly.

C. In return for assets with a fair market value of $17,500, the Company issued a demand note for $12,000 and 250 fully paid Preferred Shares having a per share Paid Up Capital equal to those currently outstanding.

D. An investor owns 100 of the Common Shares. They were purchased at a price of $15 per share. The Company redeems these shares at a price of $32 per share.

# Tax Software Assignment Problem

### *Tax Software Assignment Problem Fourteen - 1*

RadionFaux Industries Ltd. (RIL) is a Canadian controlled private corporation, located at 123 ABC Street in Ottawa, Ontario K4E 1A1. Its Ontario Corporation tax account number is 1234567. Its phone number is (613) 111-1111. It was incorporated on February 24, 1990 in Ottawa.

The government's Crown Copyright no longer permits us to use fake Business Numbers in software problems. To reduce the number of ProFile's error messages because of this, enter NR (for not registered) in the Business Number field.

The Company has 1,000 shares of common stock issued and outstanding, all of which are held by Margaret Ottawa (SIN 527-000-301).

Ms. Ottawa, the president and director of the Company, is the person who should be contacted with respect to matters concerning the Company's books and records. She is the authorized person as well as the signing officer.

RIL is a retailer of pet supplies. All of its sales occur within Canada. It has net assets of $235,000 on December 31, 2018. This includes a few investments that Ms. Ottawa inherited from her father two years earlier.

RIL owns all of the 500 common shares of OttawaFaux Inc., which holds most of the investments Ms. Ottawa inherited from her father. The common shares have a book value of $1,200,000. OttawaFaux Inc. has the same location and phone number as RadionFaux Industries Ltd. OttawaFaux Inc. has a December 31 fiscal year end. Enter NR (for not registered) in the Business Number field for OttawaFaux Inc.

OttawaFaux Inc. is also involved in earning active business income through the breeding and sale of championship dogs. It has total assets of $2,000,000 and total revenues for 2018 of $200,000. Its Taxable Capital Employed In Canada was $350,000 as at December 31, 2017, and $365,000 as at December 31, 2018.

The following information applied to RIL:

| | |
|---|---|
| Taxable Capital Employed In Canada - 2017 | $328,000 |
| Taxable Capital Employed In Canada - 2018 | 411,000 |
| Total Assets As At December 31, 2018 | 750,000 |
| RDTOH As At December 31, 2017 | 5,200 |
| Dividends Declared And Paid During 2017 | Nil |
| GRIP Balance As At December 31, 2017 | 11,750 |
| Capital Dividend Account As At December 31, 2017 | 6,000 |

RIL does not use International Financial Reporting Standards (IFRS). For the taxation year ending December 31, 2018, RIL's Income Statement, before any deduction for income taxes, was as follows:

| | |
|---|---|
| Sales Revenues | $580,000 |
| Interest On Long-Term Debt | 27,500 |
| Interest Received On Foreign Bank Account (Note 1) | 18,000 |
| Eligible Dividends On Royal Bank Shares | 17,500 |
| Non-Eligible Dividends From OttawaFaux Inc. (Note 2) | 42,000 |
| Gain On Sale Of Shares (Note 3) | 27,000 |
| Total Revenues | $712,000 |
| Cost Of Goods Sold | $208,000 |
| Amortization Expense | 122,000 |
| Other Operating Expenses | 147,000 |
| Total Expenses (Excluding Taxes) | $477,000 |
| Net Income (Before Taxes) | $235,000 |

**Note 1** This interest is net of $2,000 in taxes withheld in Ireland.

**Note 2** As a result of paying this $42,000 in dividends to RIL, OttawaFaux Inc. received a dividend refund of $14,000.

**Note 3** On March 23, 2018, RIL sold 2,700 shares of Canadian Imperial Bank of Commerce. The common shares had cost $118,800 on June 6, 2015 and were sold for net proceeds of $145,800.

**Other Information**:

1. Expenses include a deduction for charitable donations to the Ottawa Civic Hospital in the amount of $5,000.
2. RIL's Expenses include penalties of $3,500 resulting from a judgment in the Tax Court Of Canada.
3. RIL reimbursed Ms. Ottawa $34,000 for business meals and entertainment for clients and suppliers during the year.
4. During the year, RIL incurred $20,000 in landscaping costs. For accounting purposes these are being treated as a capital asset, to be amortized using the straight-line method over 10 years. The related amortization is included in the Amortization Expense shown on the Income Statement.
5. The opening UCC balances were $246,000 for Class 1, $135,000 for Class 8 and $90,000 for Class 10. The only fixed asset disposition during the year was the sale of a delivery truck. The truck had cost $35,000 and was sold for its net book value of $12,000. The only fixed asset acquisition was $52,000 in office furniture on April 1, 2018.
6. During 2018, RIL paid taxable dividends of $92,000. Of these dividends, $25,000 was designated as eligible. On September 1, 2018, RIL also elects to pay the maximum capital dividend allowable.
7. RIL allocates $60,000 of the annual business limit to OttawaFaux Inc. This is $5,000 more than OttawaFaux Inc. can utilize in 2018, but RIL cannot use the excess.
8. RIL paid quarterly income tax instalments of $8,000 each on the 20th of March, June, September and December during 2018.
9. RIL has a website describing the products it carries, but no income is generated from the website.

**Required**: Prepare the federal corporate tax return for RIL for the 2017 taxation year using the ProFile T2 corporate software program. On the ProFile schedule titled "Info", the Filing question "Complete return from GIFI?" is answered Yes by default, click No. Ignore the GIFI requirements except as follows:

*Tax Software Assignment Problem*

On GIFI Schedule 125:

- Input the total revenues less the Gain On Sale Of Shares ($685,000) on the line "Total Sales Of Goods And Services" (Code 8000).
- Choose "Realized gains / losses on sale of investments" (Code 8211) from the drop down menu under Code 8089 and input the Gain On Sale Of Shares.
- Choose "Purchases / cost of materials" (Code 8320) from the drop down menu under Cost of Sales and input the Cost of Goods Sold.
- Choose "Amortization of tangible assets" (Code 8670) from the drop down menu under Operating Expenses and input the amortization expense.
- Choose "Other expenses" (Code 9270) from the drop down menu under Operating Expenses and Other Operating Expenses.

On GIFI Schedule 100:

- Input the Net Income figure as "Cash and deposits" (Code 1000) in order to make the total assets equal to the total liabilities and equity.

Although this will not properly complete the GIFI statements, it will eliminate the warning messages that would otherwise be generated when the Net Income figure and Amortization Expense are input on Schedule 1. These GIFI entries will have no effect on the calculations in the tax return.

In addition, to prevent audit warnings, S141, "Notes Checklist", has to be completed. Assume there are no notes to the financial statements and answer "No" to any other relevant questions.

# CHAPTER 15

# Corporate Taxation And Management Decisions

## The Decision To Incorporate

### Basic Tax Considerations

#### *Deferral And Reduction*

15-1. One of the more important decisions facing the owner of a business is deciding whether or not the business should be incorporated. There are, of course, a number of non-tax considerations involved in this decision and these factors will be reviewed in this Chapter. At this point, however, we are concerned with the influence of corporate taxation on this decision.

15-2. The decision to incorporate, from both a legal and a tax point of view, has the effect of separating the business from its owners. This means that, in order for incorporated business income to be made available to the owner, it must go through two levels of taxation. First, the amount of Tax Payable applicable to the corporation will be determined. Then, when any after tax amounts are distributed to the owner, additional personal taxes will be payable on the amounts received.

15-3. This dual system of taxation may or may not be advantageous to the owner of the business. In terms of the types of tax advantage that can result from an individual incorporating business income, there are two possibilities:

> **Tax Reduction** In some situations, the total taxes that would be paid at the combined corporate and personal level will be less when the business is incorporated than would be the case if the individual had earned the business income directly as an individual proprietor.
>
> **Tax Deferral** As was noted in Paragraph 15-2, getting income from its source through a corporation and into the hands of a shareholder involves two levels of taxation. If the shareholder does not require all available income for his personal needs, after tax funds can be left in the corporation, resulting in a postponement of the second level of taxation. If the rate at which the corporation is taxed is lower than the rate at which the individual would be taxed on the direct receipt of the income, the use of a corporation provides tax deferral.

15-4. As you probably discerned while proceeding through the earlier chapters on corporate taxation, whether the presence of a corporation will provide a deferral or reduction of taxes depends on both the type of corporation and the type of income that is being earned by that business entity. An additional important factor, as will be discussed in this Chapter, is the province in which the individual and the corporation pay income taxes.

15-5. This means that there is no one answer to the question of whether incorporation will provide tax reduction and/or tax deferral. Because of this, we will devote a major section of this Chapter to examining the various possible combinations of income types and corporate classifications in order to provide you with a general understanding of the availability of these two tax features. This material begins in Paragraph 15-12.

### Using Imperfections In The Integration System

15-6. We have previously noted that the integration provisions that are contained in Canadian tax legislation are based on the assumption that certain corporate and personal tax rates prevail. Even at the federal level, actual corporate tax rates vary from the notional rates required for effective integration.

15-7. In addition, there are significant variations in the corporate tax rates used by the provinces. This means that it is unlikely that the combined federal/provincial rate in any given province will be equal to the notional combined rates assumed in the integration model. As it may be possible to use incorporation to take advantage of these imperfections in the integration system, it is important for you to understand how the imperfections can influence the decision to incorporate. We will provide a section which deals with this issue, beginning in Paragraph 15-58.

### Income Splitting

15-8. Even in situations where the use of a corporation neither reduces, nor defers significant amounts of taxes for a single individual, incorporation may be attractive to a family or other related group of individuals. In a typical family situation, it is fairly common to find some individuals earning amounts far in excess of the amount required to put them in the maximum personal tax bracket while, at the same time, other members of the group have incomes that leave them in a lower bracket or free of taxes altogether.

15-9. As was discussed in Chapter 1, if some method can be found to redistribute the aggregate family or group income from high income to low income individuals, the tax savings can be significant. While we did not discuss this in Chapter 1, using a corporation can be one of the most effective approaches to achieving income splitting goals. Given this, we will provide a section which deals with this possibility beginning in Paragraph 15-89. You should note, however, that the Tax On Split Income (TOSI) makes using a private corporation for income splitting much more difficult. (See coverage in Chapter 11.)

## Other Advantages And Disadvantages

### Advantages

15-10. Other advantages that are normally associated with the use of a corporation are as follows:

**Limited Liability** Because a corporation is a separate legal entity, the shareholders' liability to creditors is limited to the amount that they have invested. That is, creditors of the corporation can look only to the assets of the corporation for satisfaction of their claims. However, for smaller corporations, obtaining significant amounts of financing will almost always require the owners to provide personal guarantees on any loans, making this advantage somewhat illusory for this type of company. Note, however, limited liability may still be important for a smaller corporation if it is exposed to significant product or environmental claims.

**Lifetime Capital Gains Deduction** Individuals who dispose of the shares of a qualified small business corporation are eligible to claim the lifetime capital gains

deduction ($866,912 for 2019). To qualify, a business must be a Canadian controlled private corporation with substantially all of the fair market value of its assets (at least 90 percent) used in an active business carried on primarily in Canada (at least 50 percent) at the time of disposition. In addition, no one other than the seller, or related persons, can own the shares during the 24 months preceding the sale. During this 24 month period, more than 50 percent of the fair market value of the assets must have been used in active business carried on primarily in Canada. For a more complete discussion of this provision, see Chapter 11.

**Flexibility On Timing, Type And Distribution Of Income** In the case of a corporation with a single shareholder, the owner can determine when his compensation will be paid and the form that it will take (e.g., salary vs. dividends). As mentioned previously, he may also be able to use the corporate form to split income with family members.

**Foreign Taxes** Foreign estate taxes can often be avoided by placing foreign property in a Canadian corporation.

**Estate Planning** A corporation can be used in estate planning, particularly with respect to freezing the asset values of an estate (see Chapter 19).

### *Disadvantages*

15-11. Disadvantages that are normally associated with incorporation include the following:

**Use Of Losses** An individual can deduct business and unrestricted farm losses against any other source of income, including employment and property income. If the business or farm is incorporated, such losses can only be deducted against past or future corporate income. The corporation's losses belong to the corporation and cannot be used to offset income earned by the individual shareholder. This is of particular importance to operations that are just getting started as they will frequently experience significant losses in their formative years.

**Tax Credits** A corporation is not eligible for personal tax credits, such as the basic personal, tuition fee, age, pension, and disability tax credits.

**Charitable Donations** Charitable donations provide the basis for a tax credit for individuals, largely at 29 or 33 percent at the federal level. In contrast, they are a deduction in calculating Taxable Income for a corporation. In general, this deduction will not be as valuable as the tax credit that an individual would receive for donations.

**Additional Maintenance Costs** The legal, accounting, and other costs associated with maintaining a business operation will be significantly higher in the case of a corporation (e.g., the cost of filing a corporate tax return on an annual basis).

**Winding Up Procedures** The complications associated with the termination of an incorporated business will be greater than would usually be the case with a proprietorship or partnership. In addition, there may be adverse tax effects on winding up.

**We suggest you work Self Study Problems Fifteen-1 and 2 at this point.**

# Tax Reduction And Deferral

## Approach

15-12. As we have noted, whether the use of a corporation will result in a reduction or deferral of taxes will depend on the type of income being earned, as well as the type of corporation. In this section, we will examine this issue by using a basic example to consider this issue in the following situations:

- A public corporation.
- A CCPC earning active business income that is eligible for the small business deduction, and business and property income that is not eligible for the small business deduction.
- A CCPC earning investment income (net taxable capital gains and other property income, excluding dividends).
- A CCPC earning both eligible and non-eligible dividend income.

15-13. These cases should serve to provide you with a good understanding of the ability of incorporation to provide either tax reductions or tax deferral for an individual taxpayer under current rates of corporation taxation.

15-14. To assist you in understanding this material (which is covered in detail in Chapter 13), we remind you that eligible dividends include:

- Designated dividends paid by CCPCs with a positive General Rate Income Pool (GRIP) at the end of the taxation year in which the dividend is paid.
- Designated dividends paid by non-CCPCs that do not have a positive Low Rate Income Pool (LRIP) balance at the time the dividend is paid.

## Basic Example

### Data On The Individual Taxpayer

15-15. In order to consider the various results that can be achieved by incorporating a source of income, we will use a simple example in which an individual, Mr. Renaud, has access to $100,000 in income that he can either receive directly or channel through a corporation. We will assume that, before any consideration of this additional $100,000, Mr. Renaud has sufficient Taxable Income to place him in the maximum federal tax bracket of 33 percent (amounts over $210,371 for 2019). The Tax Payable on his other income is sufficient to absorb all of his personal and other tax credits.

15-16. To illustrate the effects of incorporating different types of income, several cases will be presented with varying assumptions as to the source of this income and the type of corporation that will be established. However, before turning to these cases, we will give consideration to the various personal and corporate tax rates that will be used.

### Personal Tax Rates And Tax Payable

15-17. In these examples, we will assume that Mr. Renaud lives in a province where the maximum provincial tax rate on individuals is 18 percent. As all of Mr. Renaud's additional income will be subject to this maximum rate, his combined federal/provincial marginal rate will be 51 (33 + 18) percent. The 18 percent provincial rate that we are using is approximately the 2019 average for the nine provinces other than Quebec, which has a different tax system. However, it is significantly below the maximum rate of 21 percent.

15-18. This 51 percent rate is applicable to the direct receipt of income. This means that, if Mr. Renaud receives the $100,000 in income without channeling it through a corporation, taxes of $51,000 will be paid and $49,000 will be retained.

15-19. If the income is channeled through a corporation, the situation becomes more complex. Taxes must be paid at the corporate level, leaving only part of the total income available for distribution to shareholders. When this after tax amount is distributed to the shareholders, the amount of dividends received must be grossed up, with this amount providing a basis for a credit against Tax Payable. The amounts involved will depend on whether the dividends are non-eligible (e.g., paid by a CCPC out of income that has benefited from the small business deduction), or eligible (e.g. paid by a non-CCPC out of fully taxed income):

**Non-Eligible Dividends** These dividends are grossed up by 15 percent and benefit from a federal dividend tax credit of 9/13 of the gross up. We will assume that Mr. Renaud lives in a province where the dividend tax credit on non-eligible dividends is 20 percent of the dividend gross up. This is approximately the 2019 average for the nine provinces excluding Quebec.

**Eligible Dividends** These dividends are grossed up by 38 percent and benefit from a federal dividend tax credit of 6/11 of the gross up. We will assume that Mr. Renaud lives in a province where the dividend tax credit on eligible dividends is 36 percent of the dividend gross up. This is approximately the 2019 average for the nine provinces excluding Quebec.

15-20. Using these gross up and tax credit amounts, the rates applicable to Mr. Renaud on eligible and non-eligible dividends can be calculated as follows:

| Personal Tax On Dividends | Non-Eligible Dividends | Eligible Dividends |
|---|---|---|
| Provincial Dividend Tax Credit | 20.0% | 36.0% |
| Dividends Received | 100.0% | 100.0% |
| Gross Up | 15.0% | 38.0% |
| Taxable Dividends | 115.0% | 138.0% |
| Times The Combined Federal/Provincial Tax Rate | 51.0% | 51.0% |
| Equals: Combined Federal/Provincial Tax Rate On Dividends Received | 58.7% | 70.4% |
| Less: Dividend Tax Credit [(9/13 + 20%)(15%)] | ( 13.4%) | |
| Less: Dividend Tax Credit [(6/11 + 36%)(38%)] | | ( 34.4%) |
| Effective Personal Tax Rate On Dividends Received | 45.3% | 36.0% |

15-21. For use in our examples, we will round the non-eligible rate to 45 percent. For eligible dividends, we will use 36 percent.

## Corporate Tax Rates

15-22. In making the required calculations, we will use the corporate federal tax rates that apply for the 2019 calendar year. With respect to provincial rates, we will use 2.5 percent for income eligible for the small business deduction and 13.5 percent for other income. Both of these rates are close to the average rates applicable in the nine provinces excluding Quebec. When these provincial rates are added to the corresponding federal rates, the combined rates are 11.5 percent (9% + 2.5%) for income eligible for the small business deduction and 28.5 percent (15% + 13.5%) for other income. The following table provides the rates that will be used in our examples:

| | |
|---|---|
| General Part I Tax Rate | 38% |
| Federal Tax Abatement | 10% |
| General Rate Reduction (GRR) | 13% |
| Refundable Tax On Investment Income Of A CCPC (ART) | 10-2/3% |
| Federal Small Business Deduction | 19% |
| Provincial Tax Rates | |
| Income Eligible For Federal Small Business Deduction | 2.5% |
| Income Not Eligible For Federal Small Business Deduction | 13.5% |
| Refundable Portion Of Part I Tax On Investment Income | 30-2/3% |
| Refundable Part IV Tax | 38-1/3% |

15-23. Note that the general rate reduction is not applicable to income that benefits from either the small business deduction or the M&P deduction. In addition, it is not applicable to

aggregate investment income of a CCPC which attracts the 10-2/3 percent Additional Refundable Tax (see Chapter 13)).

15-24. We will apply this basic information, in a number of different situations, in order to examine the question of whether the incorporation of $100,000 in income will serve to either reduce or defer taxes for an individual taxpayer.

## Public Corporation

### M&P Deduction

15-25. As discussed in Chapter 12, both the M&P deduction and the GRR are at the same rate. As these two provisions cannot be used simultaneously, the effective federal tax rate will not be altered by the use of the M&P deduction. Given this, we will not give separate attention to situations where a public corporation is earning income that is eligible for the M&P deduction. Keep in mind, however, that companies will continue to make the M&P calculation in those provinces where there is a favourable provincial rate for this type of income.

### General Results

15-26. With only $100,000 of income, there is no possibility that Mr. Renaud would be in a position to establish a public company. However, this case does serve to illustrate a simple calculation of corporate taxes. In addition, this same tax calculation would apply to a CCPC on amounts of active business income in excess of the CCPC's allocated annual business limit.

15-27. As discussed in Chapter 13, dividends paid by non-CCPCs, a category that includes public companies, will generally be designated as eligible. There will be situations, however, where a public corporation has an LRIP. While this raises the possibility that at least some of the dividends paid by such a company would be non-eligible, we do not feel that this situation is of sufficient importance that an illustration of the tax reduction and deferral results is warranted. It should be fairly obvious to you that for non-eligible dividends, the tax reduction results would be significantly worse than those illustrated in the following calculations.

| **Public Corporation** | |
|---|---|
| Federal Tax [(38%)($100,000)] | $38,000 |
| Federal Tax Abatement [(10%)($100,000)] | ( 10,000) |
| General Rate Reduction [(13%)($100,000)] | ( 13,000) |
| Federal Tax Payable | $15,000 |
| Provincial Tax Payable [(13.5%)($100,000)] | 13,500 |
| Corporate Tax Payable | $28,500 |
| | |
| Corporate Business Income | $100,000 |
| Corporate Tax Payable | ( 28,500) |
| Maximum Eligible Dividend Payable | $ 71,500 |
| Personal Tax On Eligible Dividends [(36%)($71,500)] | ( 25,740) |
| Income Retained By The Individual | $ 45,760 |
| | |
| After Tax Retention - With Corporation | $ 45,760 |
| After Tax Retention - Without Corporation | ( 49,000) |
| Advantage (Disadvantage) With Corporation | ($ 3,240) |

### Analysis

15-28. If the $100,000 had been received directly, $49,000 [($100,000)(1 - .51)] would be retained, an amount greater than the $45,760 that is retained when the $100,000 is flowed through a public corporation. In terms of total taxes, incorporation is clearly not desirable.

15-29. However, there is a deferral of tax on income that is left within the corporation. Taxes at the corporate level are $28,500, significantly less than the $51,000 that would be paid on the direct receipt of income. There is some question as to whether this amount of deferral would justify the payment of an additional $3,240 in taxes.

15-30. More to the point is that, in real world terms, deferral is not an issue for shareholders of publicly traded companies. In the case of private corporations with a single shareholder or a small shareholder group, these individuals can control the extent to which their corporation distributes resources. If they do not have an immediate need for funds, tax deferral can be achieved by leaving resources in their corporation.

15-31. This is not the case with large publicly traded companies. Their dividend decisions are based on a large number of factors, including corporate cash needs and the maximization of share values. The cash flow needs of individual shareholders would rarely be at the top of this list.

## Integration And Eligible Dividends

15-32. The preceding example is based on the public corporation paying eligible dividends. The government's stated goal in bringing in the eligible dividends legislation was to improve integration by lowering the total corporate and personal taxes paid on income flowed through a public company. The calculations in Paragraph 15-27 make it clear that, at current corporate tax rates, this stated goal has not been achieved.

15-33. As discussed in Chapter 7, the gross up and tax credit procedures on eligible dividends are based on a notional corporate tax rate of 27.54 percent. As the combined federal/provincial rates for 2019 average 28.5 percent, which is close to the required rate for integration to be effective, corporate tax rates are not the main problem.

15-34. The problem is with the dividend tax credit rates. Effective integration requires the combined federal/provincial tax credit to be equal to the gross up. This means that, given the federal rate of 6/11, the provincial dividend tax credit would have to be 5/11 or 45.5 percent. In actual fact, most of the provincial dividend tax credit rates are below this level, ranging from a low of 19.6 percent to a high of 50.8 percent. The average, however, at 36.2 is well below the required 45.5 percent.

### Exercise Fifteen - 1

**Subject**: Eligible Dividends And Integration

Ms. Jennifer Ashley is the owner of a number of successful CCPCs. For 2019, she has sufficient income that any additional personal income will be taxed at a combined federal/provincial rate of 45 percent. She lives in a province where the provincial tax credit on eligible dividends is equal to 47.1 percent of the gross up. Ms. Ashley has made an investment in a business venture that she anticipates will generate $100,000 of active business income during the coming year. If she retains personal ownership of this investment, she will retain $55,000 [($100,000)(1 - 45%)] after taxes. If she transfers this investment to a new private corporation, it would not be allocated any amount of the small business deduction and its income would be taxed at a combined federal/provincial rate of 26.5 percent (15% + 11.5%). She has asked your advice as to whether she should retain the investment personally, or transfer it to a new corporation. Provide the information required by Ms. Ashley.

**SOLUTION available in print and online Study Guide.**

## CCPC - Active Business Income

### General Results

15-35. A CCPC can be subject to two different tax rates on its active business income. A low rate is available on up to $500,000 of income that is eligible for the small business deduction, with a higher tax rate assessed on income that is not eligible for this valuable deduction. With respect to the provinces, there is a similar dual rate system. In addition, we will have to take into consideration the fact that dividends that have been paid out of income that has benefited from the small business deduction cannot be designated as eligible dividends.

15-36. We will continue to use the Mr. Renaud example from Paragraph 15-15 to illustrate the tax consequences of applying these two rates. While using the basic data from this example, we will consider two different cases:

**Case One** In Case One, we will assume that the corporate income is eligible for the small business deduction. This means that dividends that are received by Mr. Renaud will be non-eligible and subject to tax at a rate of 45 percent (see Paragraph 15-21).

**Case Two** In Case Two, we will assume that none of the corporate income is eligible for the small business deduction (the full amount has been allocated to an associated corporation). This means that the dividends that are received by Mr. Renaud can be designated as eligible and subject to tax at a rate of 36 percent. You will note that the results in this case are identical to those for a public corporation (see Paragraph 15-27).

| Active Business Income Of CCPC | Case One SBD Deduction | Case Two No SBD |
|---|---|---|
| Federal Tax [(38%)($100,000)] | $ 38,000 | $ 38,000 |
| Federal Tax Abatement [(10%)($100,000)] | ( 10,000) | ( 10,000) |
| Small Business Deduction [(19%)($100,000)] | ( 19,000) | N/A |
| General Rate Reduction [(13%)($100,000)] | N/A | ( 13,000) |
| Federal Tax Payable | $ 9,000 | $ 15,000 |
| Provincial Tax Payable: | | |
| At 2.5 Percent | 2,500 | N/A |
| At 13.5 Percent | N/A | 13,500 |
| Corporate Tax Payable | $ 11,500 | $ 28,500 |
| | | |
| Corporate Business Income | $100,000 | $100,000 |
| Corporate Tax Payable | ( 11,500) | ( 28,500) |
| Maximum Dividend Payable | $ 88,500 | $ 71,500 |
| Personal Tax At 45 Percent (Non-Eligible) | ( 39,825) | N/A |
| Personal Tax At 36 Percent (Eligible) | N/A | ( 25,740) |
| Income Retained By The Individual | $ 48,675 | $ 45,760 |
| | | |
| After Tax Retention - With Corporation | $ 48,675 | $ 45,760 |
| After Tax Retention - Without Corporation | ( 49,000) | ( 49,000) |
| Advantage (Disadvantage) With Corporation | ($ 325) | ($ 3,240) |

### Analysis

15-37. As can be seen in the preceding table, there is a disadvantage for income flowed through a corporation, even when that income is eligible for the small business deduction. In the absence of the small business deduction, the corporate choice results in a $3,240 disadvantage. Note that this is identical to the results found in our analysis of public corporation taxation (see Paragraph 15-27).

15-38. In both cases the use of a corporation results in deferral of taxes. In the small business deduction case the corporate taxes are only $11,500, as compared to $51,000 when the

income is received directly. When this significant amount of deferral is combined with the small tax disadvantage associated with this alternative, using the corporate route when the small business deduction is available seems advantageous. Note, however, the benefit of the deferral can only be achieved if the funds are left in the corporation.

15-39. The situation is less clear when the small business deduction is not available. As corporate taxes are only $28,500, well below the $51,000 that would be paid on direct receipt of income, there is significant deferral. However, the price that is paid for this is $3,240 in extra taxes to be paid when the income is distributed by the corporation. If Mr. Renaud is in a position to leave the funds in the corporation for some length of time, it seems likely that he would find this to be a worthwhile trade off.

15-40. A further point related to tax deferral is sometimes overlooked. Any income that is left in the corporation should not be left idle. If it is not needed in the principal activities, it is likely that it will be invested in assets that will produce investment income. If this income is taxed as investment income, the result will be prepayment of taxes at the corporate level. This will be illustrated in a later example when we look at the taxation of investment income received by a Canadian controlled private corporation.

## Exercise Fifteen - 2

**Subject:** Incorporation Of Active Business Income

Keith Slater has an unincorporated business that he anticipates will have active business income of $126,000 for the taxation year ending December 31, 2019. He has employment income in excess of $300,000, with additional amounts subject to a provincial tax rate of 16 percent. The provincial dividend tax credit is equal to 27 percent of the dividend gross up for non-eligible dividends. Also in his province of residence, the corporate tax rate is 3 percent on income eligible for the small business deduction and 12 percent on other income. Mr. Slater has asked your advice as to whether he should incorporate this business. Advise him with respect to any tax deferral that could be available on income left in the corporation and on any tax savings that could be available if all of the income is paid out as dividends.

**SOLUTION available in print and online Study Guide.**

### *"Bonusing Down" Active Business Income*

15-41. A traditional tax planning technique for owners of CCPCs that have active business income in excess of their annual business limit is to "bonus down". As our example has shown, income that is eligible for the small business deduction benefits from significant tax deferral, and only a small tax cost. In contrast, if a CCPC's Taxable Income does not benefit from the small business deduction, a tax cost is incurred. As shown in Paragraph 15-36, the after tax retention on $100,000 of income that is not eligible for the small business deduction is $3,240 less than if the income is received directly.

15-42. When it is likely that a CCPC will have Taxable Income in excess of its annual business limit ($500,000 if there are no associated companies and no applicable grinds), the simple solution is for the owner of the CCPC to pay himself sufficient additional salary that the corporation's Taxable Income will be reduced to the amount of income that is eligible for the small business deduction.

> **EXAMPLE** In our example, if Mr. Renaud had a CCPC with active business income of $600,000, paying additional salary of $100,000 would result in after tax retention of $49,000 on receipt of this salary. This is, of course, $3,240 higher than the $45,760 that would be paid if the $100,000 ($600,000 - $500,000) that is not eligible for the small business deduction was taxed at the corporate level, with the residual amount being paid to Mr. Renaud as eligible dividends.

15-43. Tax practitioners sometimes find it difficult to convince some individuals that bonusing down is a good idea. The problem is that bonusing down involves paying taxes out of the owner-manager's personal funds. It is not uncommon to encounter individuals who, even in situations where there is a clear cut tax advantage to using this procedure, will simply refuse to make the required salary payments. While this is usually not a rational decision, it appears to reflect a greater level of comfort for an owner-manager when he does not have to pay the taxes directly out of his personal assets.

### Electing Out Of The Small Business Deduction

15-44. ITA 89(11) allows a CCPC to make an election not to be a CCPC. A related provision, ITA 89(12), allows a corporation to revoke the ITA 89(11) election and return to being a CCPC. Note that the use of either of these provisions creates a deemed year end. In some circumstances, this may have adverse tax consequences (e.g., shortened loss carry forward periods).

15-45. The good news is that making this election will allow the corporation to designate its dividends as eligible. The bad news is that it will lose the small business deduction. While there may be some situations where this election may be useful, the fact that it appears to have a significant tax cost would suggest that its application would be rare.

## CCPC - Investment Income Other Than Dividends

15-46. As was discussed in Chapter 13, the aggregate investment income of a CCPC is taxed at full corporate rates. Neither the small business deduction nor the general rate reduction is available to offset these rates. In addition, there is an additional refundable tax under ITA 123.3 (the ART) equal to 10-2/3 percent of investment income.

15-47. To offset this high level of taxation, a dividend refund is available at a rate of 38-1/3 percent of dividends paid. Note, however, investment income that is eligible for a refund does not add to the corporation's GRIP balance. This means that it does not contribute to the corporation's ability to pay eligible dividends.

15-48. Continuing our Mr. Renaud example from Paragraph 15-15, if Mr. Renaud incorporates, as it is greater than $50,000, his $100,000 in investment income would likely result in a grind of his small business limit. However, as his corporation would have no other income, this would not be relevant in this example. Given this, his after tax retention on $100,000 of investment income received by a CCPC, compared to the direct receipt of investment income, would be as follows:

| **Investment Income Of CCPC** | |
|---|---|
| Federal Tax [(38%)($100,000)] | $ 38,000 |
| Additional Refundable Tax [(10-2/3%)($100,000)] | 10,667 |
| Federal Tax Abatement [(10%)($100,000)] | ( 10,000) |
| Federal Tax Payable | $ 38,667 |
| Provincial Tax Payable [(13.5%)($100,000)] | 13,500 |
| Corporate Tax Payable | $ 52,167 |
| | |
| Non-Eligible RDTOH Balance [(30-2/3%)($100,000)] | $ 30,667 |
| | |
| Corporate Investment Income | $100,000 |
| Corporate Tax Payable | ( 52,167) |
| Net Corporate Income Before Dividend Refund | $ 47,833 |
| Dividend Refund (See Note) | 29,734 |
| Maximum Dividend Payable | $ 77,567 |
| Personal Tax On Non-Eligible Dividends At 45 Percent | ( 34,905) |
| Income Retained By The Individual | $ 42,662 |

| | |
|---|---|
| After Tax Retention - With Corporation | $ 42,662 |
| After Tax Retention - Without Corporation | ( 49,000) |
| Advantage (Disadvantage) With Corporation | ($ 6,338) |

**Note** The dividend refund is the lesser of the balance in the Non-Eligible RDTOH account ($30,667) and 38-1/3 percent of taxable dividends paid. The available cash of $47,833 would support a dividend of $77,567 ($47,833 ÷ .61667), which includes a potential dividend refund of $29,734 [(38-1/3%)($77,567)]. This is less than the balance in the Non-Eligible RDTOH so a dividend refund of $29,734 is available which leaves a Non-Eligible RDTOH balance of $933.

15-49. As the corporate taxes of $52,167 exceed $51,000 that would be paid on direct receipt of the $100,000, there is no deferral of taxes through the use of a corporation. When this fact is combined with the $6,338 reduction in after tax retention, it is clear that the use of a corporation in this situation would be a bad idea.

## Exercise Fifteen - 3

**Subject:** Incorporation Of Interest Income

David Slater has investments that he anticipates will earn interest income of $126,000 for the year ending December 31, 2019. He has employment income in excess of $300,000, with additional amounts subject to a provincial tax rate of 18 percent. The provincial dividend tax credit is equal to 27 percent of the dividend gross up for non-eligible dividends. Also in his province of residence, the corporate tax rate is 3 percent on income eligible for the small business deduction and 12 percent on other income. Mr. Slater has asked your advice as to whether he should transfer these investments to a corporation in which he would own all of the shares. Advise him with respect to any tax deferral that could be available on income left in the corporation and on any tax savings that could be available if all of the income is paid out as dividends.

**SOLUTION available in print and online Study Guide.**

**We suggest you work Self Study Problem Fifteen-3 at this point.**

## CCPC - Dividend Income

### *Possible Sources Of Dividend Income*

15-50. A CCPC can only designate dividends as eligible to the extent that it has a balance in its GRIP. Dividend receipts that increase this balance enable the CCPC to designate its dividends as eligible. In general, dividends received by a CCPC will be subject to Part IV tax. The exception to this is if the dividend is received from a connected company that did not claim a dividend refund as a result of paying the dividend. Dividend income effects for a CCPC can be summarized as follows:

**Eligible Dividends** Any dividends received (portfolio or connected company) that have been designated eligible will be added to the CCPC's GRIP balance. Non-eligible dividends have no effect on the CCPC's GRIP balance.

**Portfolio Dividends** These dividends will be subject to Part IV tax regardless of whether they are eligible or non-eligible.

**Connected Company Dividends** These dividends can be eligible or non-eligible and may be subject to Part IV tax depending on:

- If a dividend refund results from the dividend payment, the dividends will be subject to Part IV tax. The fact that there is a dividend refund generally means that the connected company had investment income.
- If no dividend refund results from the dividend payment, the dividends will not be subject to Part IV tax. The fact that there is no dividend refund generally means that the connected company had income that benefitted from the small business deduction.

## *Analysis*

15-51. Recalling that Mr. Renaud would pay taxes on:

- eligible dividends received at a rate of 36 percent (see Paragraph 15-21), his after tax retention on the direct receipt of $100,000 of these dividends would be $64,000 [($100,000)(1 - .36)], and
- non-eligible dividends received at a rate of 45 percent (see Paragraph 15-21), his after tax retention on the direct receipt of $100,000 of these dividends would be $55,000 [($100,000)(1 - .45)].

A comparison of this retention with the after tax results from using a corporation, assuming the connected company paid non-eligible dividends, would be as follows:

| **Dividend Income Of CCPC** | Eligible Portfolio Dividends | Non-Eligible Portfolio Dividends | Connected With Refund | Connected No Refund |
|---|---|---|---|---|
| Corporate Dividend Income | $100,000 | $100,000 | $100,000 | $100,000 |
| Part IV Tax Payable At 38-1/3% | ( 38,333) | ( 38,333) | ( 38,333) | N/A |
| Net Corporate Income Before Dividend Refund | $ 61,667 | $ 61,667 | $ 61,667 | $100,000 |
| Dividend Refund At 38-1/3% | 38,333 | 38,333 | 38,333 | N/A |
| Maximum Dividend Payable | $100,000 | $100,000 | $100,000 | $100,000 |
| Personal Tax On: | | | | |
| Eligible Dividends At 36% | ( 36,000) | | | |
| Non-Eligible Dividends At 45% | N/A | ( 45,000) | ( 45,000) | ( 45,000) |
| Income Retained By Individual | $ 64,000 | $ 55,000 | $ 55,000 | $ 55,000 |

| | | | | |
|---|---|---|---|---|
| After Tax Retention: | | | | |
| With Corporation | $ 64,000 | $ 55,000 | $ 55,000 | $ 55,000 |
| Without Corporation | ( 64,000) | ( 55,000) | ( 55,000) | ( 55,000) |
| Advantage (Disadvantage) | Nil | Nil | Nil | Nil |

15-52. In all cases, the dividends that can flow through to the investor total the full $100,000 that was received by the corporation. As a result, the total Tax Payable on dividends is the same whether the investment is held personally or in a corporation.

15-53. The Part IV tax does, however, influence the conclusions on tax deferral. If the dividends are subject to Part IV tax, this 38-1/3 percent tax is higher than the 36 percent tax rate on eligible dividends received by Mr. Renaud, and less than the 45 percent tax rate applicable to non-eligible dividends. As a result, there is a prepayment of taxes on eligible dividends that are flowed through a corporation.

15-54. The situation is different in the absence of a Part IV tax in that no taxes will be assessed on dividends received at the corporate level. This, of course, provides for a significant deferral of Tax Payable on dividends not subject to Part IV tax.

## Conclusions On Tax Reductions And Deferrals

15-55. The results from the preceding cases can be summarized as follows:

| | Corporate Taxes Before Dividend Refund | After Tax Retention On Flow Through |
|---|---|---|
| Public Corporation ($100,000 Of Income) (Paragraph 15-27): | $28,500 | $45,760 |
| CCPC ($100,000 Of Active Business Income): | | |
| Eligible For SBD (Paragraph 15-36) | $11,500 | $48,675 |
| Not Eligible For SBD (Paragraph 15-36) | 28,500 | 45,760 |
| CCPC ($100,000 Of Interest Income): | | |
| Investment Income (Paragraph 15-48) | $52,167 | $42,662 |
| CCPC ($100,000 Of Dividend Income): | | |
| Eligible Portfolio Dividends (Paragraph 15-51) | $38,333 | $64,000 |
| Non-Eligible Portfolio Dividends (Paragraph 15-51) | 38,333 | 55,000 |
| Connected With Refund (Paragraph 15-51) | 38,333 | 55,000 |
| Connected No Refund (Paragraph 15-51) | Nil | 55,000 |

15-56. The conclusions reached can be summarized as follows:

**Tax Reduction Available** As illustrated previously, Mr. Renaud is subject to taxes on the direct receipt of income, other than dividends, at a rate of 51 percent, while his rate on the direct receipt of dividends is 36 percent (eligible) or 45 percent (non-eligible). This means that his after tax retention resulting from the direct receipt of income would be:

- $49,000 On $100,000 Of Business Or Interest Income
- $64,000 On $100,000 Of Eligible Dividend Income
- $55,000 On $100,000 Of Non-Eligible Dividend Income

Comparing these amounts to those in the preceding table, there is no case where there is a reduction in taxes through the use of a corporation. The least unfavourable scenario is where a CCPC is earning active business income. In this case, the tax cost of $325 is relatively small.

When a public company is involved, the use of a corporation results in the payment of $3,240 more taxes and correspondingly less retention ($45,760 vs. $49,000). The same $3,240 shortfall results when a CCPC is earning active business income that is not eligible for the small business deduction. The situation is even worse for investment income earned by a CCPC. The shortfall here is $6,338 ($42,662 vs. $49,000).

In the case of dividend income received by a CCPC, the after tax results are the same whether the income is received directly or flowed through a corporation.

**Tax Deferral Available** Tax deferral occurs when income is not distributed to shareholders and taxes paid at the corporate level are less than those that would be paid if the income was received directly by the shareholder. On direct receipt of relevant amounts, Mr. Renaud would pay the following amounts in income tax:

- $51,000 On $100,000 Of Business Or Interest Income
- $36,000 On $100,000 Of Eligible Dividend Income
- $45,000 On $100,000 Of Non-Eligible Dividend Income

Comparing these amounts to the corporate tax amounts in the preceding table, we find that there is tax deferral in some, but not all cases.

There is deferral in the case of public companies, with taxes on business or interest income of only $28,500 at the corporate level.

The worst case scenario is when a CCPC earns interest income. Corporate taxes are $52,167, as compared to $51,000 on direct receipt of income.

In the cases where Part IV tax is applicable, the $38,333 that would be required when that tax is assessed, is larger than the $36,000 that would be paid on the direct receipt of eligible dividends, but smaller than the $45,000 that would be paid on the direct receipt of non-eligible dividends.

The most significant amounts of deferral are available to a CCPC earning active business income eligible for the small business deduction, or dividend income that is not subject to Part IV tax. In the case of income eligible for the small business deduction, taxes at the corporate level are $11,500, $39,500 less than the $51,000 that would have been paid on the direct receipt of this income.

Even if a CCPC has active business income that is not eligible for the small business deduction, taxes on $100,000 of this additional income would only be $28,500, $22,500 less than the $51,000 payable on direct receipt of this amount of income.

There is also deferral in the case of dividend income when it is not subject to Part IV tax. However, for dividends to not be subject to Part IV tax, they must be received from a connected corporation that did not receive a dividend refund as a result of their payment. This would generally involve payment from a CCPC earning business income. This means that deferral would have been available at the level of the paying corporation, without the use of an additional corporation to receive the dividends.

15-57. These conclusions are based on assumed provincial personal and corporate tax rates as outlined previously. While the rates we have used are within the range of current actual rates, the use of other rates will produce different results. As these differences can be important, we will give some attention to this issue in the next section of this Chapter.

## Exercise Fifteen - 4

**Subject:** Incorporation Of Interest And Dividend Income

One of your clients has asked your advice on whether he should transfer a group of investments to a new Canadian controlled private corporation that can be established to hold them. He anticipates that the transferred investments will have the following amounts of income during the 2019 taxation year:

| | |
|---|---|
| Eligible Dividends On Portfolio Investments | $46,000 |
| Non-Eligible Dividends From 100 Percent Owned Subsidiary | |
| (A Dividend Refund Of $29,000 Will Be Received by The Payor) | 87,000 |
| Interest Income | 32,000 |

Although he has employment income of over $250,000, your client needs all of the income that is produced by these investments as he has newborn quintuplets. On additional amounts of income, your client is subject to a provincial tax rate of 18 percent. The provincial dividend tax credit is equal to 5/11 of the dividend gross up for eligible dividends and 4/13 of the dividend gross up on non-eligible dividends. The corporation will be subject to a provincial tax rate of 2.5 percent on income eligible for the small business deduction and 12 percent on other income. The corporation will make the maximum eligible dividend designation. Provide the requested advice and explain your conclusions.

**SOLUTION available in print and online Study Guide.**

## Exercise Fifteen - 5

**Subject:** Incorporation Of Capital Gains

One of your clients has asked your advice on whether she should transfer a group of investments to a new corporation that can be established to hold them. The corporation will be a Canadian controlled private corporation and she anticipates that, during the coming year, the market value of these investments will increase by $92,000. No other income will be generated by the investments.

For the year ending December 31, 2019, your client has employment income in excess of $250,000 and will sell these investments by the end of the year to finance her trip across Canada by bicycle. None of these investments are eligible for the lifetime capital gains deduction. The corporation will be subject to a provincial tax rate of 3.5 percent on income eligible for the small business deduction and 12 percent on other income. On additional personal income, your client is subject to a provincial tax rate of 16 percent. The provincial dividend tax credit is equal to 4/13 of the dividend gross up for non-eligible dividends.

Provide the requested advice, including an explanation of your conclusions.

**SOLUTIONS available in print and online Study Guide.**

**We suggest you work Self Study Problem Fifteen-4 at this point.**

# Provincial Taxes And Integration

## Introduction

15-58. We have presented a number of different cases dealing with the question of whether it is better, both in terms of tax reduction and tax deferral, for an individual to receive income directly or, alternatively, channel that income through a corporation. In doing so, we have given consideration to both the type of income being earned, and whether the corporation is eligible for the small business deduction on the income.

15-59. The conclusions that we reached were presented in Paragraph 15-56. We found that, while there were several cases the use of a corporation provided some degree of tax deferral, there were no scenarios that provided a reduction in taxes.

15-60. It is important to note, however, that all of our conclusions were based on calculations that used average provincial tax rates. As discussed in other Chapters of this text, there are wide variations in all of these provincial amounts. Further, these variations can provide results that are different than those summarized in Paragraphs 15-55 and 15-56. For example, if a province legislates a tax free period of time for corporations that operate within its jurisdiction, this will make the use of a corporation more attractive in that province.

15-61. This section will be concerned with how variations in provincial tax rates can influence the decision to incorporate. In doing so, we will not attempt to delineate every possible combination of rates and type of income. With 10 provinces and 3 territories, several different types of income, and various corporate, individual and dividend tax credit rates to consider, there are literally hundreds of possible combinations. Given this, our goal will be to help you understand how changes in each of the provincial rates will act to influence conclusions on the use of a corporation for tax deferral or tax reduction purposes.

## Tax Deferral

15-62. The analysis of using a corporation to provide tax deferral is very straightforward. If the combined federal/provincial tax rate on corporations is less than the combined federal/provincial tax rate on individuals, the use of a corporation provides for deferral. Some examples of this analysis are as follows:

> **Alberta CCPC Earning Active Business Income** The combined federal/provincial tax rate on the corporation would be 11 percent. For an Alberta resident individual in the maximum tax bracket, the combined federal/provincial rate would be 48 percent. In this case, the use of a corporation would clearly provide deferral.
>
> **Manitoba CCPC Earning Investment Income** The combined federal/provincial tax rate on the corporation would be 50.7 percent. For a Manitoba resident individual in the maximum tax bracket, the combined federal/provincial rate would be 50.4 percent. In this case, there would also be an insignificant amount of deferral.
>
> **British Columbia Public Corporation (or CCPC Earning Over $500,000 In Active Business Income)** The combined federal/provincial tax rate on the corporation or income would be 27 percent. For a British Columbia resident individual in the maximum tax bracket, the combined federal/provincial rate would be 49.8 percent. In this case, the use of a corporation would clearly provide deferral.

15-63. We would remind you not to look at the deferral issue in isolation from other considerations. If the income will be distributed out of the corporation in the future, both tax deferral and tax reduction must be considered. If all of the income will be distributed immediately, tax deferral is irrelevant.

## Tax Reduction

### *Introduction*

15-64. The question of whether a corporation can be used to reduce tax involves a more complex analysis. In looking at the after tax retention when income is received directly, only the combined federal/provincial tax rate on individuals is relevant. However, in looking at after tax retention of income that is flowed through a corporation, three factors must be considered:

1. The combined federal/provincial tax rate on individuals.
2. The combined federal/provincial tax rate on corporations.
3. The combined federal/provincial dividend tax credit.

15-65. As we will demonstrate in the next section, the first of these factors is not influential in this analysis. For any given combination of corporate tax rates and dividend tax credit rates, the conclusion on whether a corporation can be used to reduce taxes will be the same, without regard to the tax rate on individuals.

15-66. The real determinate here is the relationship between the combined corporate tax rate and the combined dividend tax credit. As our later analysis will show, if the combined dividend tax credit exceeds the combined corporate taxes paid, the use of a corporation will reduce taxes. Alternatively, if the credit is less than the corporate taxes, direct receipt of income will be preferable.

### *Provincial Rates On Individuals*

15-67. Maximum combined federal/provincial tax rates on individuals range from a low of 47.5 percent in Saskatchewan to a high of 54 percent in Nova Scotia. Note, however, variations in the combined rate influence both the direct receipt of income and the amounts that are flowed through a corporation. That is, a high tax rate on individuals will reduce after tax retention on both the direct receipt of income, as well as on the after tax retention of income flowed through a corporation. Correspondingly, a low tax rate on individuals will increase both types of after tax retention.

15-68. What this means is that, for any specific combination of corporate tax rate and dividend tax credit rate, the tax rate applicable to individuals will not alter the conclusion on whether the use of a corporation will serve to reduce taxes. While the amount of the advantage or disadvantage associated with the use of a corporation will vary with the tax rate on individuals, the conclusion on the ability of a corporation to reduce taxes will not. This is illustrated by the following example.

**EXAMPLE** A CCPC has $100,000 of active business income that will be taxed at a combined federal/provincial rate of 11.5 percent (9.0% + 2.5%). The provincial dividend tax credit on non-eligible dividends is equal to 4/13 of the gross up. We will consider two cases, the first based on the assumption that Niko Parma is taxed at a combined federal/provincial rate of 48 percent (33% federal, plus 15% provincial), the second based on the assumption that Nela Parma is taxed at a combined federal/provincial rate of 54 percent (33% federal, plus 21% provincial).

**ANALYSIS** If the individuals received the $100,000 directly, Niko's after tax retention would be $52,000 [($100,000)(1 - .48)] and Nela's would be $46,000 [($100,000)(1 - .54)]. The after retention if the income is flowed through a corporation would be as follows:

| Comparison - Rates For Individuals | Niko (48%) | Nela (54%) |
|---|---|---|
| Corporate Income | $100,000 | $100,000 |
| Corporate Taxes At 11.5 Percent | ( 11,500) | ( 11,500) |
| Available For Dividends | $ 88,500 | $ 88,500 |
| | | |
| Non-Eligible Dividends Received | $ 88,500 | $ 88,500 |
| Gross Up (15%) | 13,275 | 13,275 |
| Taxable Dividends | $101,775 | $101,775 |
| Individual Tax Rate | 48% | 54% |
| Taxes Before Dividend Tax Credit | $ 48,852 | $ 54,959 |
| Dividend Tax Credit (Equal Gross Up) | ( 13,275) | ( 13,275) |
| Individual Taxes | $ 35,577 | $ 41,684 |
| | | |
| Dividends Received | $ 88,500 | $ 88,500 |
| Individual Taxes | ( 35,577) | ( 41,684) |
| After Tax Retention With Corporation | $ 52,923 | $ 46,816 |
| | | |
| After Tax Retention With Corporation | $ 52,923 | $ 46,816 |
| Direct Receipt After Tax Retention | ( 52,000) | ( 46,000) |
| Advantage With Corporation | $ 923 | $ 816 |

15-69. Despite using individual tax rates that vary significantly, the result is the same for both Niko and Nela. The use of a corporation provides tax reduction for both individuals. As an average corporate rate was used in this example, the saving is fairly modest. Note that the conclusion on tax reduction would be the same if a lower or higher corporate tax rate were used. However, the amount would be larger (lower rate) or smaller (higher rate).

### *Provincial Dividend Tax Credit And Provincial Corporate Tax Rates*

15-70. As can be seen in the preceding example, the major determinate of whether the use of a corporation will provide tax reduction is the relationship between the combined federal and provincial taxes paid at the corporate level, and the combined federal/provincial dividend tax credit. As the federal components of these values do not vary, the provincial rates become the determining factor.

15-71. The rules here can be stated fairly simply:

**Favourable To Incorporation** If the combined federal/provincial dividend tax credit exceeds the combined taxes paid at the corporate level, the use of a corporation will reduce taxes and provide a higher level of after tax retention. This is sometimes referred to as over integration.

**Unfavourable To Incorporation** If the combined federal/provincial dividend tax credit is less than the combined taxes paid at the corporate level, the use of a corporation will increase taxes and reduce the amount of after tax retention. This is sometimes referred to as under integration.

## Examples - Effects Of Provincial Rates On Integration

### Data

15-72. The range of values in the 9 provinces, excluding Quebec, for provincial corporate tax rates and provincial dividend tax credit rates are as follows:

**Corporate Tax Rates** The provincial rates for public companies (which would also apply to CCPCs whose active business income is not eligible for the small business deduction) range from 11.5 percent to 16 percent. When these are combined with the federal rate of 15 percent, the combined rates range from 26.5 percent to 31 percent.

The provincial rates for CCPCs earning income eligible for the small business deduction range from zero percent to 6 percent. When these are combined with the federal rate of 9 percent, the combined rates range from 9 percent to 15 percent.

**Dividend Tax Credit Rates** The provincial rates for eligible dividends range from 19.6 percent of the gross up to 50.8 percent of the gross up. When combined with the federal rate of 6/11 (54.5%) of the gross up, the combined rates range from 74.1 percent of the gross up to 105.3 percent of the gross up.

The provincial rates on non-eligible dividends range from 6 percent of the gross up to 25.8 percent. When combined with the federal rate of 9/13 (69.2%) of the gross up, the combined rates range from 75.2 percent to 95 percent of the gross up.

15-73. The following two examples illustrate the effects of provincial corporate tax rates and provincial dividend tax credit rates on the after tax retention for individuals. They both use the following information:

**EXAMPLE** The company has $100,000 in business income. The shareholders will be taxed at a combined federal/provincial rate of 45 percent. If the $100,000 of income is received directly by the individuals, they will retain $55,000 [($100,000)(1 - .45)].

### *Public Company Paying Eligible Dividends*

15-74. Dealing first with public companies that are paying eligible dividends, we will consider the following three alternative cases:

**Perfect Integration** For a public company paying eligible dividends, perfect integration occurs when the combined federal/provincial tax rate on corporations is 27.53623 percent (for this example, we have rounded this to 27.536) and the dividend tax credit is equal to one (6/11 + 5/11).

**Worst Case** Here we will use a combination of the highest corporate tax rate (31%) and the lowest dividend tax credit rate (74.1%).

**Best Case** Here we will use a combination of the lowest corporate tax rate (26.5%) and the highest dividend tax credit rate (105.3%).

**ANALYSIS** If the income is flowed through a corporation, the after tax retention under the three cases described would be as follows:

| Public Company Eligible Dividends | Perfect Integration | Worst Case (31%/74.1%) | Best Case (26.5%/105.3%) |
|---|---|---|---|
| Corporate Income | $100,000 | $100,000 | $100,000 |
| Corporate Taxes: | | | |
| At 27.536 Percent | ( 27,536) | | |
| At 31 Percent (Worst) | | ( 31,000) | |
| At 26.5 Percent (Best) | | | ( 26,500) |
| Available For Dividends | $ 72,464 | $ 69,000 | $ 73,500 |
| | | | |
| Eligible Dividends Received | $ 72,464 | $ 69,000 | $ 73,500 |
| Gross Up (38%) | 27,536 | 26,220 | 27,930 |
| Taxable Dividends | $100,000 | $ 95,220 | $101,430 |
| Individual Tax Rate | 45% | 45% | 45% |
| Taxes Before Dividend Tax Credit | $ 45,000 | $ 42,849 | $ 45,644 |
| Dividend Tax Credit: | | | |
| [($27,536)(1)] | ( 27,536) | | |
| [($26,220)(74.1%)] (Worst) | | ( 19,429) | |
| [($27,930)(105.3%)] (Best) | N/A | | ( 29,410) |
| Individual Taxes | $ 17,464 | $ 23,420 | $ 16,234 |
| | | | |
| Eligible Dividends Received | $72,464 | $69,000 | $73,500 |
| Individual Taxes | ( 17,464) | ( 23,420) | ( 16,234) |
| After Tax Retention With Corporation | $55,000 | $45,580 | $57,266 |
| | | | |
| After Tax Retention With Corporation | $55,000 | $45,580 | $57,266 |
| Direct Receipt After Tax Retention | ( 55,000) | ( 55,000) | ( 55,000) |
| Advantage (Disadvantage) | Nil | ($ 9,420) | $ 2,266 |

**ANALYSIS - Continued** This example clearly illustrates the influence of varying provincial rates for corporate taxes and dividend tax credits. The results range from a $9,420 reduction in after tax retention with the use of a corporation, to a $2,266 increase in after tax retention with the use of a corporation. Considering that only $100,000 of income was involved, this represents a significant difference in the results achieved through using a corporation.

## CCPC Paying Non-Eligible Dividends

15-75. This example calculates the after tax retention of non-eligible dividends paid by a CCPC. We will consider the following three alternative cases:

**Perfect Integration** As you may recall from earlier examples in the text, for a CCPC paying non-eligible dividends, perfect integration occurs when the combined federal/provincial tax rate on corporations is 13.043 percent and the dividend tax credit is equal to one (9/13 + 4/13).

**Worst Case** Here we will use a combination of the highest corporate tax rate (15%) and the lowest dividend tax credit rate (75.2%).

**Best Case** Here we will use a combination of the lowest corporate tax rate (9%) and the highest dividend tax credit rate (95%).

| CCPC - Non-Eligible Dividends | Perfect Integration | Worst Case (15%/75.2%) | Best Case (9%/95%) |
|---|---|---|---|
| Corporate Income | $100,000 | $100,000 | $100,000 |
| Corporate Taxes: | | | |
| At 13.043 Percent | ( 13,043) | | |
| At 15 Percent (Worst) | | ( 15,000) | |
| At 9 Percent (Best) | | | ( 9,000) |
| Available For Dividends | $ 86,957 | $ 85,000 | $ 91,000 |
| | | | |
| Non-Eligible Dividends Received | $ 86,957 | $ 85,000 | $ 91,000 |
| Gross Up (15%) | 13,043 | 12,750 | 13,650 |
| Taxable Dividends | $100,000 | $ 97,750 | $104,650 |
| Individual Tax Rate | 45% | 45% | 45% |
| Taxes Before Dividend Tax Credit | $ 45,000 | $ 43,988 | $ 47,093 |
| Dividend Tax Credit: | | | |
| [($13,043)(1)] | ( 13,043) | | |
| [($12,750)(75.2%)] (Worst) | | ( 9,588) | |
| [($13,650)(95.0%)] (Best) | N/A | | ( 12,968) |
| Individual Taxes | $ 31,957 | $ 34,400 | $ 34,125 |
| | | | |
| Non-Eligible Dividends Received | $86,957 | $85,000 | $91,000 |
| Individual Taxes | ( 31,957) | ( 34,400) | ( 34,125) |
| After Tax Retention With Corporation | $55,000 | $50,600 | $56,875 |
| | | | |
| After Tax Retention With Corporation | $55,000 | $50,600 | $56,875 |
| Direct Receipt After Tax Retention | ( 55,000) | ( 55,000) | ( 55,000) |
| Advantage (Disadvantage) | Nil | ($ 4,400) | $ 1,875 |

**ANALYSIS** The results for the best and worst cases for both eligible and non-eligible dividends can be compared as follows:

| Advantage (Disadvantage) Of Using A Corporation | Eligible Dividends | Non-Eligible Dividends |
|---|---|---|
| Worst Case | ($9,420) | ($4,400) |
| Best Case | 2,266 | $1,875 |

In both cases the results are skewed towards the disadvantage side. That is, the worst case scenario has a larger negative result than the positive result that comes from the application of the best combination of corporate tax rates and dividend tax credits. This would suggest that, on the average, the effect of provincial variations in corporate tax rates and dividend tax credits do not result in a reduction in taxes when compared to the direct receipt of income.

## Summary: Tax Deferral And Tax Reduction

15-76. The preceding examples make it clear that the province in which the corporation and the individual is taxed (which may not be the same province) is a significant factor in deciding whether the use of a corporation will be advantageous. Depending on the type of corporation and the type of income, whether tax deferral is possible depends heavily on the province in which the income is taxed. In a similar fashion, the applicable combination of corporate tax rate and dividend tax credit will determine whether the use of a corporation will serve to reduce taxes.

**We suggest you work Self Study Problem Fifteen-5 at this point.**

# Tax Free Dividends

## Tax Rates On Dividends

15-77. In this Chapter we are concerned with owner-managed businesses and these will typically be CCPCs. In most cases, the bulk of their income will either be active business income that benefits from the small business deduction or, alternatively, investment income that qualifies the corporation for a refund of taxes paid. While such corporations may have a positive GRIP account that will allow them to pay eligible dividends, most of their dividends will be non-eligible. Given this, our analysis will focus on non-eligible dividends that are subject to the gross up of 15 percent.

15-78. For an individual in the 33 percent federal tax bracket, subject to an 18 percent provincial tax rate on Taxable Income, and living in a province where the dividend tax credit is equal to 4/13 of the gross up on non-eligible dividends and 5/11 on eligible dividends, the combined federal/provincial rate is:

- 43.7% on non-eligible dividends received [(33% + 18%)(115%) - (9/13+ 4/13)(15%)],
- 32.4% on eligible dividends received [(33% + 18%)(138%) - (6/11 + 5/11)(38%)], and
- 25.5% on capital gains [(33% + 18%)(1/2)].

15-79. The rate on non-eligible dividends is well above that applicable to eligible dividends and capital gains. However, it is well below the maximum 51 percent rate (33% + 18%) that would be applicable to most other types of income. In addition to the fact that dividends are taxed at favourable rates, the structure of the dividend tax credit system is such that a substantial amount of dividends can be received without incurring any taxation. This very desirable result will be explained and illustrated in this section on tax free dividends.

## Use Of Tax Credits

### *Credits In General*

15-80. For 2019, every individual has a personal credit against federal Tax Payable based on $12,069 multiplied by the 15 percent rate applicable to the lowest federal tax bracket. This means that the first $12,069 of an individual's income can be received tax free.

15-81. Extending this analysis, it can be said that, for most types of income, the amount that can be received tax free is limited to the total tax credit base amounts available to the individual. That is, for every dollar of tax credit amount, one dollar of income can be received on a tax free basis. There are two exceptions to this:

**Dividends** An individual with only the basic personal credit of $1,810 [(15%)($12,069)] can receive tax free dividends slightly more than double the $12,069 base for this credit. More specifically, such an individual can receive $26,364 in non-eligible dividends without incurring any liability for federal tax. (See the calculations in Paragraph 15-86.) Note that, depending on the amount of the provincial dividend tax credit, this amount may or may not be totally free of provincial tax.

**Charitable Donations** The tax credit on amounts of charitable donations over $200 is based on 29 or 33 percent, rather than the 15 percent applicable to other credit amounts. Since the 33 percent rate is applicable if income is taxed at 33 percent, we will only consider the credit rate of 29 percent in this analysis. This means that a dollar of charitable donations in excess of $200 will allow an individual in the lowest tax bracket to receive $1.93 in tax free income. More specifically, a $1 contribution in excess of $200 is eligible for a tax credit of $0.29. This $0.29 would eliminate $0.29 of tax payable, the amount of tax that an individual in the lowest bracket would pay on $1.93 of income [(15%)($1.93) = $0.29]. This is unlikely to be an important exception in that it would be unusual for someone in the 15 percent federal tax bracket to be making significant charitable donations.

### Special Rules For Dividends

15-82. How can an individual receive such a large amount of dividends without paying federal tax? The answer lies in the dividend gross up and tax credit mechanism. For an individual in the lowest tax bracket, the increase in tax associated with one dollar of non-eligible dividends received compared to one dollar of interest income can be calculated as follows:

| Tax Increase Per $1 | Dividend | Interest |
|---|---|---|
| Cash Received | $1.0000 | $1.0000 |
| Gross Up At 15 Percent | .1500 | N/A |
| Taxable Income | $1.1500 | $1.0000 |
| | | |
| Federal Tax Payable At 15 Percent | $0.1725 | $0.1500 |
| Federal Dividend Tax Credit [(9/13)($0.15)] | ( 0.1038) | N/A |
| Increase In Federal Tax Payable | $0.0687 | $0.1500 |

15-83. For each dollar of non-eligible dividends received, an individual must add a taxable dividend of $1.15 ($1 + $0.15 gross up) to Taxable Income. For individuals in the lowest federal tax bracket, the federal tax on this amount will be $0.1725 [($1.15)(15%)]. However, there will be a federal credit against this tax payable equal to 9/13 of the gross up, or $0.1038 [(9/13)($0.15)]. This means that there is only a $0.0687 increase in federal tax for each one dollar increase in non-eligible dividends. This is in contrast to an increase in federal tax of $0.15 for each one dollar increase in interest income (i.e., a 15 percent rate of increase). As the preceding calculations demonstrate, dividend income uses up an individual's available tax credits at a much lower rate than most other types of income, i.e., a 6.87 percent rate.

15-84. For example, one dollar of interest income will use up one dollar [($1.00)($.15 ÷ $.15)] of an individual's personal tax credit base of $12,069. In contrast, one dollar of non-eligible dividends received will use up only $0.458 of this base [($1.00)($.0687 ÷ $.15)]. This means that, in comparison with other types of income, a much larger amount of dividends can be received before an individual's tax credits are absorbed and taxes will have to be paid.

15-85. The amount of dividends that can be received tax free by an individual with no other source of income is a function of the total amount of personal tax credits available and can, in fact, become a fairly large amount.

## Tax Free Amounts For 2019

15-86. For 2019, ignoring possible tax credits other than the basic personal and spousal, the amount of non-eligible dividends that can be received free of federal tax by a single individual, and by an individual with a dependent spouse (or eligible dependant) with no other source of income is calculated in the table which follows. Note that, in the dependent spouse case, the grossed up amount of the dividends exceeds $47,630, the top of the 15 percent federal tax bracket. This means that some of this dividend will be taxed at a higher federal rate of 20.5 percent.

| | Single Individual | Dependent Spouse |
|---|---|---|
| Non-Eligible Dividends Received | $26,364 | $47,301 |
| Gross Up Of 15 Percent | 3,955 | 7,095 |
| Taxable Income | $30,319 | $54,396 |
| Taxed At 15% | ( 30,319) | ( 47,630) |
| Taxed At 20.5% | $ Nil | $ 6,766 |
| Federal Tax At 15% | $4,548 | $ 7,145 |
| Federal Tax At 20.5% | Nil | 1,387 |
| Dividend Tax Credit (9/13 Of Gross Up) | ( 2,738) | ( 4,912) |
| Basic Personal Credit [(15%)($12,069)] | ( 1,810) | ( 1,810) |
| Spousal Credit [(15%)($12,069)] | N/A | ( 1,810) |
| Federal Tax Payable | Nil | Nil |

**Note** While this is not relevant to our analysis in this section, you might wish to note that, with respect to eligible dividends, the tax free amount for a single individual would be $58,566, and $75,758 for an individual with a dependent spouse.

15-87. There may or may not be provincial tax payable on the amounts in the preceding table. A number of provincial factors would have to be considered. These include the provincial tax rates, the provincial tax brackets, the provincial personal tax credit amounts and the provincial dividend tax credit rates.

15-88. The alternative minimum tax is not a factor in determining the amount of non-eligible dividends that can be received on a tax free basis. As the dividend tax credit is not available in the calculation of the alternative minimum tax payable, the dividend gross up is deducted in the calculation of adjusted taxable income for alternative minimum tax purposes. Given this, the $40,000 basic exemption that is provided by the alternative minimum tax legislation, combined with the $12,069 basic personal tax credit (plus the $12,069 spousal credit in the dependent spouse example), would serve to eliminate the alternative minimum tax on the tax free non-eligible dividends calculated in Paragraph 15-86. However, alternative minimum tax may be a consideration when a large amount of eligible dividends are involved. See Chapter 11 for our coverage of alternative minimum tax.

# Income Splitting

## Basic Concept

15-89. In Chapter 1 we provided a very simple example of income splitting. As illustrated in that example, if an individual can find a way to share a large block of income with related parties in lower tax brackets, the result can be a significant reduction in taxes, not just in the current year, but on an ongoing basis.

15-90. While the examples presented earlier in this Chapter suggested that there are limits on an individual's ability to reduce or defer taxes through the use of a corporation, these examples did not take into consideration that a corporation could be used to effectively implement income splitting. This possibility is further enhanced by the fact that, as discussed in the preceding section, individuals without other sources of income can receive substantial amounts of dividends without paying any taxes at the federal level.

15-91. Note, however, income splitting only works when the Tax On Split Income (TOSI) does not apply to the recipient of the split income. The 2018 extension of the TOSI to related adults has made it much more difficult to effectively use a corporation in an income splitting strategy.

**We suggest you work Self Study Problem Fifteen-6 at this point.**

# Shareholder Benefits Including Loans

## The Owner-Manager Environment

15-92. Much of the material in this Chapter deals with owner managed corporations. These are typically CCPCs with either a single shareholder or a small group of shareholders. When there is a shareholder group, the group often consists of members of a single family.

15-93. Unlike the situation with publicly traded companies, in this environment the owner-manager is subject to few constraints on the use of the corporate assets. In effect, he is in a position to provide significant benefits to himself and other related individuals.

15-94. This situation is complicated by the fact that some things that might be considered benefits are, in fact, necessary to the operation of the business. For example, the owner-manager may need an automobile to use in carrying out the business of the corporation. If he provides himself with a $30,000 Honda, this cost would appear to be a legitimate business expense. However, if he provides himself with a $450,000 Bentley, there is some question as to whether calling on clients really requires this type of vehicle.

15-95. As was discussed in earlier Chapters, the CRA deals with potential abuses in the area of corporate ownership and leasing of vehicles by:

- restricting the corporation's ability to deduct the costs of owning or leasing vehicles; and
- assessing taxable benefits for personal use of corporate vehicles.

15-96. Another problem area is travel costs. Most owner-managers have legitimate reasons to travel on matters related to corporate business. However, there is always the temptation of trying to find some business reason for spending a week in a luxury resort in Phoenix. In fact, there is a thriving industry that encourages such behaviour. It is not difficult to find a 30 minute seminar on human resource management that is conveniently conducted just before the ski lifts open at Whistler.

15-97. Unlike the situation with automobiles, there are no provisions that deal specifically with travel costs. Such costs are only subject to the general constraint that requires a business purpose for their incurrence. In addition, they must be reasonable in the circumstances. Not surprisingly, there are frequent disputes in this area.

## Shareholder Benefits Other Than Loans

15-98. ITA 15(1) deals with situations where a corporation has provided a benefit to a shareholder that does not appear to have a business purpose. Examples of this type of situation would include:

- a corporation providing a shareholder with a jet for personal use;
- a corporation building a swimming pool at a shareholder's personal residence; or
- a corporation selling assets to a shareholder at prices that are substantially below fair market value.

15-99. When any of these events occur, the shareholder is required to include the value of these benefits or appropriations in his income. Such amounts will not be considered dividends and, as a consequence, they will not be eligible for the dividend tax credit.

15-100. A further point here is that, when an amount is included in a shareholder's income under ITA 15(1), IT-432R2 indicates that the corporation is not allowed to deduct the amount that has been included in the shareholder's income.

> **EXAMPLE** A corporation provides a shareholder with a $10,000 holiday trip to Italy.
>
> **ANALYSIS** ITA 15(1) requires the inclusion of the $10,000 cost of the trip in the shareholder's income. Despite the fact that this amount is being taxed in the hands of the shareholder, the corporation would not be able to deduct the cost of the trip.

15-101. It would seem clear, given this non-deductibility, that corporations should avoid providing benefits that will be assessed to shareholders under ITA 15(1).

## Shareholder Loans

### General Rule

15-102. ITA 15(2) is applicable when a corporation makes a loan to a shareholder or an individual connected to, or affiliated with, a shareholder. Under ITA 15(2.1), persons are connected for this purpose if they do not deal with each other at arm's length. When such loans are made, this general rule requires that the full principal amount of the loan be included in the Net Income For Tax Purposes of the recipient of the loan (the shareholder or the person connected to the shareholder) in the taxation year in which the loan is made.

15-103. This general rule applies without regard to the amount of interest paid on the loan. Note, however, in periods subsequent to the inclusion of the principal amount of the loan in the income of the shareholder, there is no imputed interest benefit, even in cases where the loan is on an interest free basis.

15-104. Under this general rule, the granting of the loan to a shareholder has the same tax consequences as the payment of an equivalent amount of salary to the shareholder. However, there are two important differences:

- Taxes paid on salary cannot normally be recovered by repaying the salary. In contrast, when all or part of a shareholder loan that has been included in the taxpayer's income under ITA 15(2) is repaid, the amount of the repayment can be deducted from Net Income For Tax Purposes under ITA 20(1)(j).
- Unlike salary payments, the corporation cannot deduct the loan even when the shareholder must include the loan in income. If the shareholder is going to be taxed on the principal of a loan, it is generally preferable for the corporation to pay salary, rather than to extend a loan.

### Exceptions To The General Rule

15-105. There are three exceptions to this general rule that are available to shareholders, without regard to whether or not they are also employees of the corporation. They can be described as follows:

**Non-Resident Persons** ITA 15(2.2) indicates that the general rule does not apply to indebtedness between non-resident persons. This means that, if both the corporation and the shareholder receiving the loan were non-residents, the principal amount of any loan would not have to be included in income.

**Loans In Ordinary Course Of Business** ITA 15(2.3) indicates that the general rule does not apply when the loan is in the ordinary course of the corporation's business. Included in this exception would be such situations as a customer, who is also a shareholder, taking advantage of an on-going promotion by a furniture store that provides interest free loans to purchase furniture. In addition, ITA 15(2.3) notes that this would apply to loans made by a corporation that is in the business of making loans. This covers situations where, for example, an individual happens to be a shareholder of the bank that provides him with a personal loan.

**Repayment Within One Year** ITA 15(2.6) indicates that the general rule does not apply when the loan is repaid within one year after the end of the taxation year of the lender or creditor in which the loan was made, or the indebtedness arose. If, for example, a corporation with a June 30 year end extended a $100,000 loan to a shareholder on January 1, 2019, the $100,000 would not have to be included in income if it is repaid, in full, by June 30, 2020. Any part of the balance that is unpaid on that date would, in fact, have to be included in the taxpayer's 2019 income.

A further point with respect to this exception is that IT-119R4 indicates that this exception is not available when the repayment is part of a series of loans and repayments. The primary evidence of this type of situation would be a repayment near the end of a corporate taxation year, followed by a loan for a similar amount early in the following corporate taxation year.

15-106. Additional exceptions to the general rule requiring the principal of shareholder loans to be included in income involve situations where the shareholder is also an employee of the corporation making the loan. These exceptions are found in ITA 15(2.4) and can be described as follows:

**Not Specified Employee** ITA 15(2.4)(a) indicates that loans made to a shareholder, who is an employee, are not subject to the general rule if the shareholder is not a specified employee. This exception applies without regard to the purpose of the loan. A specified employee is one who, at any time of the year, owns 10 percent or more of any class of the shares of the corporation, or who does not deal at arm's length with the corporation. For example, an arm's length employee who owns less than 1 percent of the shares purchased through stock options.

**Dwelling Loans** ITA 15(2.4)(b) indicates that loans made to a shareholder, who is an employee, or the spouse or common-law partner of the employee, to acquire a dwelling to live in are not subject to the general rule.

**Stock Acquisition Loans** ITA 15(2.4)(c) indicates that loans made to a shareholder, who is an employee, to acquire shares in the lending corporation or a corporation related to the lending corporation, are not subject to the general rule.

**Motor Vehicle Loans** ITA 15(2.4)(d) indicates that loans made to a shareholder, who is an employee, to acquire a motor vehicle to be used in employment duties, are not subject to the general rule.

15-107. In order for these exceptions to apply, the following conditions must be met:

- the loan must be made to the individual because he is an employee, not because he is a shareholder [ITA 15(2.4)(e)]; and
- at the time the loan is made, bona fide arrangements must be made to repay the loan within a reasonable period of time [ITA 15(2.4)(f)].

15-108. The first of these conditions can create significant problems for owner-managers of private corporations wishing to obtain loans from their corporations. In order to avoid having the principal amount of the loan included in Net Income For Tax Purposes, the owner-manager must demonstrate that he received the loan because of his role as an employee.

15-109. In order to do this, the owner-manager will likely have to make similar loans available to all employees with duties similar to those of the owner-manager. That is, if the company gives the owner-manager a $100,000, low interest loan to purchase a residence, such loans would have to be made available to all employees with duties similar to those of the owner-manager. If this is not the case, the CRA is likely to conclude that the owner-manager received the loan because of his role as a shareholder.

15-110. A further problem would arise if, as would not be uncommon in owner-managed situations, there are no other senior employees of the business, or no other employees at all. It is not clear in this case whether the owner-manager would be able to demonstrate that he received a loan in his capacity as an employee. However, the CRA will look at the loan practices of other similar corporations as an approach to making this determination.

### Imputed Interest Benefit

15-111. It was previously noted that, if the principal amount of a shareholder loan is included in the taxpayer's income, there is no imputed interest benefit related to a low rate or interest free loan. However, if the loan is exempted from the general inclusion in income rule by one of the exceptions described in Paragraphs 15-105 and 15-106, ITA 80.4(2) is applicable and a benefit may be assessed. The analogous benefit for employees, which was discussed in Chapter 3, is assessed under ITA 80.4(1).

**EXAMPLE** On July 1, 2019, Andros Ltd., a CCPC with a taxation year that ends on December 31, extends a $100,000 loan to its only shareholder, George Andros. The loan is interest free and, because it will be repaid in January, 2020, the $100,000 principal amount does not have to be included in his income. Assume the prescribed rate throughout 2019 is 2 percent.

**ANALYSIS** For 2019, Mr. Andros will be assessed a taxable benefit under ITA 80.4(2) equal to $1,000 [(2% - Nil)($100,000)(6/12)]. In the examples in IT-421R2, "Benefits To Individuals, Corporations, And Shareholders From Loans Or Debt", interest is calculated on the basis of the number of months the loan is outstanding. While not illustrated, calculations could also be based on the number of days the loan is outstanding. We would remind you that, if the loan proceeds are invested in income producing assets, the imputed interest that is assessed on the loan will be deductible.

15-112. In the fairly common situation where the shareholder also works as an employee of the business, the benefit may be assessed under either ITA 80.4(1) or ITA 80.4(2). If the benefit is assessed under ITA 80.4(1), it will be classified as employment income. In contrast, if it is assessed under ITA 80.4(2), it will be considered property income. There are additional differences when the loan is made to assist an employee/shareholder with the purchase of a home.

15-113. In the case of a home purchase loan, for the first five years the loan is outstanding, the benefit assessed to an employee under ITA 80.4(1) will use a rate no higher than the prescribed rate that prevailed when the loan was made. Should the rate go down, the employee is entitled to use the lower prescribed rate for the benefit calculation (see Chapter 3 for examples of this procedure). Alternatively, in the case of a home purchase loan to a shareholder, the ITA 80.4(2) benefit must be calculated using the actual quarterly prescribed rates that prevail over the term of the loan.

## Exercise Fifteen - 6

**Subject:** Shareholder Loans - Car Purchase

Ms. Martha Rourke is an employee of Rourke Inc., a large private company in which her husband owns 70 percent of the outstanding shares. Ms. Rourke owns the remaining 30 percent of the shares. On July 1, 2019, she receives a $50,000 interest free loan that will be used to purchase an automobile to be used in her employment duties. The loan is to be repaid on June 30, 2023. Assume the prescribed rate for all of 2019 is 2 percent. What are the tax implications of this loan for Ms. Rourke in 2019?

## Exercise Fifteen - 7

**Subject:** Shareholder Loans - Term Outstanding

On June 1, 2019, Generic Inc. loans $162,000 to its principal shareholder, Ms. Jan Fisk, in order to finance her gambling debts. Generic Inc. has a taxation year that ends on June 30. The loan is interest free. Assume that, during all periods, the relevant prescribed rate is 2 percent. What are the tax consequences to Ms. Fisk if the loan is repaid (1) on January 1, 2020 and (2) on December 31, 2020?

**SOLUTIONS available in print and online Study Guide.**

## Exercise Fifteen - 8

**Subject:** Shareholder Loans - Home Purchase

On November, 1, 2019, Hasid Ltd. loans Mr. Aaron Hasid, the CEO and principal shareholder of the Company, $123,000 in order to assist in his purchase of a principal residence. The Company has a taxation year that ends on December 31. The loan does not bear interest and, during all periods, assume that the relevant prescribed rate is 2 percent. The loan is to be repaid in four equal annual instalments, the first occurring on October 31, 2020. What are the tax consequences of this loan to Mr. Hasid? State any assumptions that you have made in providing your answer.

**SOLUTIONS available in print and online Study Guide.**

**We suggest you work Self Study Problems Fifteen-7 and 8 at this point.**

# Management Compensation

## General Principles

### *Salary As The Bench Mark*

15-114. The most obvious and straightforward way to compensate managers is to pay salaries. Provided they are reasonable, the amounts are a deductible expense to the corporation. At the same time, they are fully taxable to the recipient, rendering such payments neutral in terms of tax planning. For large publicly traded corporations, where the managers are not the principal owners of the business, salary is the usual starting point in negotiating management compensation. However, for some high income executives, stock based compensation may be of greater importance than salary.

15-115. Even with a public corporation, however, the tax effects of various methods of compensation should not be ignored. By paying salaries, a corporation receives a deduction from Taxable Income in the year of accrual, while the recipient employee receives an equal addition to Taxable Income in the year of payment.

15-116. Any form of compensation that creates an excess of the corporation's deductions over the employee's inclusions creates an aggregate tax savings. In addition, any form of compensation that is deductible to the corporation prior to inclusion in the income of the employee involves tax deferral. These considerations can allow for improved after tax benefits to the employee or, alternatively, a lower after tax cost to the corporation.

### *Tax Effective Alternatives*

15-117. Some simple examples of compensation features that can be used to defer or reduce the payment of taxes are as follows:

- **Registered Pension Plans** Within prescribed limits, a corporation can deduct contributions to Registered Pension Plans in the year of contribution. These contributions will not become taxable to the employee until they are received as a pension benefit, resulting in an effective tax deferral arrangement. In addition to tax effectiveness, such plans can promote loyalty and reduce employee turnover.
- **Deferred Profit Sharing Plans** In a fashion similar to Registered Pension Plans, amounts that are currently deductible to the corporation are deferred with respect to inclusion in the employee's Taxable Income. As with registered pension plans, these plans can also promote loyalty and reduce employee turnover.
- **Provision Of Private Health Care Plans** The premiums paid by the corporation for such benefits as dental plans can be deducted in full by the corporation and will not be

considered a taxable benefit to the employee.

- **Stock Options** Stock options provide employees with an incentive to improve the performance of the enterprise. In addition, for CCPCs, taxation of any benefits resulting from the options is deferred until they are exercised or sold (for a full discussion of the deferral of stock option benefits, see Chapter 3). Further, the value of the employment benefit received is enhanced by the fact that, in general, one-half of the amount can be deducted in the calculation of Taxable Income.

  From the point of view of the corporation, evaluation of stock option compensation is more complex. Discouraging the use of options is the fact that no tax deduction is available for the granting of options. However, IFRS 2, *Share-Based Payment*, requires that the estimated value of options be charged to expense for accounting purposes when they are granted, despite the fact that the cost of issuing stock options is not deductible for tax purposes.

15-118. Changes in tax legislation over the years have served to restrict the tax benefits associated with employee compensation. Perhaps most importantly, the rules related to taxable benefits on employer provided automobiles can be quite unfavourable, in some cases resulting in a taxable benefit that exceeds the value derived from having use of the vehicle. The rules related to employee fringe benefits and employee stock options were covered in Chapter 3. Chapter 10 contained coverage of deferred compensation plans and this Chapter 15 included coverage of shareholder loans.

## Salary Vs. Dividends

15-119. For large public corporations, there is little point in considering the tax benefits related to salary/dividend trade-offs. The dividend policy of public corporations is normally based on considerations that extend well beyond the compensation that is provided to the management group of the company.

15-120. In situations where the manager of the business is also an owner, such an individual is in a position to receive compensation in the form of either salary or dividends. If there are no other owners involved in the decision, the choice is completely at the discretion of the owner-manager and tax factors will generally be an important consideration in making this decision. The choice between compensation in the form of salary or in the form of dividends, the salary vs. dividend decision, is the subject of the remainder of this Chapter.

# Salary Vs. Dividends For The Owner - Manager

## The Basic Trade-Off

### *Example - Data*

15-121. To illustrate the basic trade-off that is involved in salary vs. dividend decisions, assume that Ms. Olney owns all of the shares of a corporation that has $100,000 in Taxable Income, and that she has sufficient property income from other sources to place her in the 51 percent federal/provincial tax bracket (33% federal rate plus 18% provincial rate).

15-122. If the full $100,000 of corporate income is paid to Ms. Olney in the form of salary, it can be deducted by the corporation and will reduce the corporation's Taxable Income to nil. This means that no Part I taxes will be paid at the corporate level. However, the $100,000 will be taxed at Ms. Olney's marginal rate of 51 percent. This means that she will pay tax of $51,000 and be left with after tax funds of $49,000.

15-123. If no salary is paid to Ms. Olney, corporate taxes will be assessed and any remaining amount, after adjustments for any refundable taxes, will be paid in dividends. This amount will be subject to personal tax and the resulting after tax cash flow to her can be determined. These amounts, which are dependent on the type of corporation and the type of income earned, were calculated earlier in this Chapter. The results of those calculations were summarized in Paragraph 15-55. You may wish to refer to this summary as you work through the remainder of this Chapter.

### Analysis Of The Example

15-124. In looking at the question of whether or not to incorporate an income source, we looked at the possibilities for both tax deferral and tax reduction through the use of a corporation. In salary vs. dividend decisions, we are not concerned with deferral. The question we need to answer here is:

> "What is the most tax effective way to have a corporation provide its owner-manager with a required amount of after tax income?"

15-125. There is, of course, no deferral available on amounts that are to be removed from the corporation.

15-126. In comparing Ms. Olney's $49,000 retained with the various results listed in Paragraph 15-55, in all cases flowing business or property income through a corporation resulted in lower after tax retention. Even in the case of a CCPC earning income that is eligible for the small business deduction, the after tax retention was $48,675, which is lower than the $49,000 that would be retained through direct receipt of the $100,000.

15-127. This would suggest that, in general, salary should be used. However, the preceding analysis is based on a number of assumptions with respect to provincial tax rates on personal and corporate income. In addition, other factors such as RRSP contributions, CPP contributions and payroll tax costs have been ignored. These factors will be considered in the following material.

## Other Considerations

### Provincial Tax Rates And Credits

15-128. The results that were presented in Paragraph 15-55 assumed a provincial tax rate on individuals of 18 percent, a provincial dividend tax credit on non-eligible dividends equal to 20 percent of the gross up, and provincial rates on corporations for income eligible for the small business deduction and other types of income of 2.5 and 13.5 percent, respectively. While these numbers are fairly representative, they are not the only possible rates.

15-129. In assessing the importance of these differences, you should recognize that the payment of salaries is analogous to the direct receipt of income. That is, if a corporation has $100,000 in income and pays this entire amount in salaries, there will be no corporate Tax Payable. Further, the taxes paid by the individual on the salary will be similar to the taxes that would be paid if the income were received directly. This means that the comparison of salary payments with dividends involves the same type of analysis as the comparison of the after tax retention from the direct receipt of income with the after tax retention resulting from channeling income through a corporation.

15-130. Given this, we can discuss the effect of varying provincial tax rates on the salary vs. dividend decision by using the conclusions reached in the comparison of the direct receipt vs. flow through decisions. Direct receipt vs. flow through decisions were considered in Paragraphs 15-58 through 15-76. Applying that analysis to salary vs. dividend decisions, the following statements can be made:

> **Tax Rates For Individuals** In the analysis contained in Paragraphs 15-67 through 15-69, we noted that higher tax rates on individuals made the use of a corporation more attractive from the point of view of deferring taxes on income retained within the corporation. Here, however, we are concerned only with amounts that will be distributed, either in the form of dividends or in the form of salary and, as a consequence, tax deferral is not an issue. This means that the level of individual tax rates is not a major issue in this type of decision. This point is illustrated with the example found in Paragraph 15-68.
>
> **Dividend Tax Credit And Corporate Tax Rates** For integration to work, the combined federal/provincial dividend tax credit must be equal to the combined corporate taxes paid.

- **Eligible Dividends** For eligible dividends subject to a 38 percent gross up, this would require a combined corporate tax rate of 27.54 percent and a dividend tax credit equal to the gross up. This in turn would require a provincial corporate tax rate of 12.54 percent [27.54 - (38 - 10 - 13)] and a provincial dividend tax credit of 5/11 of the gross up (1.0 - 6/11).
- **Non-Eligible Dividends** For non-eligible dividends (the type usually paid by a CCPC) subject to a 15 percent gross up, this would require a combined corporate tax rate of 13.043 percent and a dividend tax credit equal to the gross up. This requires a provincial corporate tax rate of 4.043 percent [13.043 - (38 - 10 - 19)] and a provincial dividend tax credit equal to 4/13 of the gross up (1.0 - 9/13).

The examples in Paragraphs 15-74 and 15-75 illustrate the results of applying the current range of values for corporate tax rates and dividend tax credit rates in all of the Canadian provinces. While these examples were designed to illustrate the desirability of using a corporation, they can also be used to evaluate salary vs. dividend decisions. As noted, paying salary is, from a tax point of view, the equivalent of direct receipt of income.

Analyzing these examples in the context of salary/dividend decisions, it is clear that, in situations where the dividend tax credit exceeds the corporate taxes paid, paying dividends will result in lower taxes than would be the case with paying salary. Similarly, when the dividend tax credit is less than the corporate taxes paid, the payment of salary, all other things being equal, will result in lower taxes.

### *Dividend Benefit - Income Splitting*

15-131. When a corporation is used for income splitting purposes, amounts may be distributed to individuals with little or no other source of income. As was noted in Paragraph 15-86, $26,364 in non-eligible dividends can be paid to such an individual without any federal tax liability being incurred. The fact that this is a much larger amount than can be distributed tax free in any other form clearly favours the use of dividends for distributions of corporate assets in these circumstances.

15-132. A constraint on this approach is the Tax On Split Income (TOSI). If TOSI is applicable, amounts received by a specified individual will have all of this income subject to tax at the maximum federal rate of 33 percent. This will often make it difficult to implement an income splitting strategy involving corporate dividends.

### *Dividend Benefit - CNIL Reduction*

15-133. An individual's Cumulative Net Investment Loss (CNIL) is the cumulative amount by which investment expenses exceed investment income since 1987 (see Chapter 11 for an explanation of this amount, as well as the general provisions of the lifetime capital gains deduction). An individual's ability to make a deduction under the provisions of the lifetime capital gains deduction is reduced, on a dollar-for-dollar basis, by the balance in the CNIL account. This means that, if an individual contemplates selling shares of a qualified small business corporation, or an interest in a qualified farm or fishing property, sensible tax planning would suggest the elimination of any CNIL balance.

15-134. For an individual whose income is provided by his owner-managed corporation, dividends can assist with this problem. The receipt of dividends reduces the CNIL by $1.15 for each $1.00 of non-eligible dividends received. In contrast, salary payments leave this balance unchanged. Another possibility, if the corporation has an amount owing to the shareholder, is to pay interest to the shareholder on the balance outstanding. This interest would also decrease any CNIL.

### *Salary Benefit - Earned Income For RRSP And CPP*

15-135. One of the most attractive features of the Canadian income tax system is the fact that individuals can make deductible contributions to RRSPs. Not only are the contributions deductible at the time that they are made, once inside the plan they enjoy the tremendous

benefits associated with tax free compounding over, what may be, a period of many years. Most individuals will want to take advantage of these provisions.

15-136. Dividends do not constitute Earned Income for the purposes of determining the maximum RRSP contributions, nor do they count as pensionable earnings on which CPP contributions can be based. As a result, if the owner-manager has no other source of Earned Income (e.g., employment income from a source other than his corporation), it will be necessary for the corporation to pay salary if the individual wishes to make RRSP and CPP contributions.

15-137. The maximum for CPP pensionable earnings for 2019 is $57,400. In order to be eligible for the maximum CPP payments at retirement, salary of at least the maximum pensionable earnings for the year should be paid. With the 2020 RRSP limit at $27,230, if the owner-manager has no other source of Earned Income, a 2019 salary of at least $151,278 will be required to make the maximum RRSP contribution for 2020 [(18%)($151,278) = $27,230]. Note that RRSP deduction room can be carried forward, but there is no equivalent carry forward for the CPP program.

### Salary Benefit - Earned Income For Child Care Costs

15-138. If an individual is in a position to deduct child care costs, they are limited to two-thirds of earned income. Salary payments would add to this limit while dividends would not. For a detailed discussion of the deductibility of child care costs, see Chapter 9.

### Salary Benefit - Corporate Tax Savings Carry Over

15-139. In a particular year, an owner-manager may wish to withdraw amounts in excess of the earnings of the corporation. If this happens, there will be no current tax savings associated with the payment of salaries, a fact that would tend to make the payment of such amounts less attractive.

15-140. However, payment of salaries in this situation would serve to create a loss carry over and, if we assume that the loss carry over can be used in some past or future year, the corporate tax savings associated with the payment of salaries would not be lost. The savings, however, will be deferred in the case of a carry forward and this means that, to properly evaluate the payment of salaries in this situation, consideration would have to be given to the time value of money.

### Salary Cost (Possible) - Provincial Payroll Taxes

15-141. With respect to provincial payroll taxes, five provinces and two territories assess such taxes. A summary of the various rates are as follows:

**British Columbia** (Employer Health Tax) No tax on the first $500,000 of payroll. Excess is taxed at up to 1.95 percent with the maximum rate of 1.95 percent applied to total payroll of $1.5 million or more.

**Ontario** (Employer Health Tax) No tax on the first $490,000 of payroll. Excess is taxed at up to 1.95 percent with the maximum rate of 1.95 percent applied to total payroll of over $5 million.

**Manitoba** (Health And Post-Secondary Education Levy) No tax on the first $1.25 million of payroll. Excess is taxed at rates between 2.15 to 4.3 percent.

**Newfoundland/Labrador** (Health And Post-Secondary Education Levy) No tax on the first $1.3 million of payroll. Excess is taxed at a rate of 2 percent.

**Quebec** (Health Services Fund) Quebec also has a complex system which includes exemptions for certain employers. When applicable the tax rate ranges from 1.25 percent to 4.26 percent of payroll.

**Territories** (Payroll Tax) Nunavut and the Northwest Territories tax all payroll at a rate of 2 percent. This tax is employee paid, unlike the employer paid preceding payroll taxes listed. There is no payroll tax in the Yukon.

## Salary Costs - CPP And EI

15-142. In our example from Paragraph 15-121, we ignored the fact that salaries cannot be paid without contributions being made to the CPP. In addition, some provinces levy a payroll tax on salaries and wages as described in the preceding paragraph. These costs can constitute a significant reduction in the after tax cash flow associated with the payment of salaries.

15-143. With respect to CPP contributions, 2019 employee contributions are based on 5.1 percent of $57,400 (maximum pensionable earnings), less a basic exemption of $3,500. This results in a maximum employee contribution for 2019 of $2,749. The employer is required to withhold and remit this contribution from salary paid and contribute an amount that is equal to the employee's contribution. This brings the total CPP cost of paying salaries of $57,400 or more to $5,498.

15-144. As covered in Chapter 4, if an individual pays more CPP contributions than is required, perhaps because he has changed employers, he is refunded the excess through his tax return. Form PD24, Application for a Refund of Overdeducted CPP Contributions or EI Premiums, provides a way for employers who have made excess contributions for an employee to recover the excess.

15-145. If an owner-manager owns more than 40 percent of the voting shares of the corporation, he cannot participate in the Employment Insurance (EI) program. While generally not relevant in the situations covered here, an employee's maximum EI premium for 2019 is 1.62 percent of $53,100 (maximum insurable earnings), with no exemption, an amount of $860. The employer must contribute 1.4 times the employee's premium, an amount of $1,204. This results in a total cost of $2,064 for an employee with maximum insurable earnings in excess of $53,100.

## Salary Benefit - CPP And Canada Employment Tax Credits

15-146. While CPP is an added cost of choosing the salary alternative, the payment of these costs provides a benefit to the individual in the form of future CPP benefit payments, as well as a benefit from the CPP tax credit. You will recall from Chapter 4 that this credit is equal to 15 percent of amounts paid by the employee. This provides a maximum credit of $412 on the payment of the 2019 maximum CPP of $2,749. Note that this would not be a consideration if the individual has other sources of income which required the payment of maximum CPP.

15-147. A further benefit of paying salary is the Canada employment credit of $183 [(15%)($1,222)] for 2019. Unless the individual has other sources of employment income in excess of the base amount for this credit, the Canada Employment credit is only available on the payment of salary by the corporation.

## Example Extended

15-148. Returning to our example of Ms. Olney from Paragraph 15-121, as the owner of 100 percent of the shares of the corporation, she is not eligible to participate in the EI program. In addition, assume the province in which she lives assesses a 2 percent payroll tax to finance its health care program and provides a provincial credit for CPP contributions at a 6 percent rate. Her corporation is a Canadian controlled private corporation and all of its $100,000 in income is eligible for the small business deduction. Given this income and the costs associated with paying salary, the maximum salary that could be paid to Ms. Olney would be $95,496, a figure that would result in no corporate Tax Payable.

| | |
|---|---|
| Pre-Tax Corporate Income | $100,000 |
| Employer's CPP Contribution | ( 2,749) |
| Gross Salary [($100,000 - $2,749) ÷ 1.02] | ( 95,344) |
| Payroll Tax [(2%)($95,344)] | ( 1,907) |
| Corporate Taxable Income | Nil |

15-149. If $95,344 is paid to Ms. Olney as salary, her personal taxes are as follows:

| | |
|---|---|
| Combined Tax Before Credits [(33% + 18%)($95,344)] | $48,625 |
| Credit For Employee's CPP Contribution | |
| [(15% + 6%)($2,749)]* | ( 577) |
| Canada Employment Credit [(15%)($1,222)] | ( 183) |
| Personal Tax Payable | $47,865 |

*We have assumed that Ms. Olney has sufficient property income to place her in the maximum federal tax bracket. This income would absorb other tax credits and, as a consequence, only the CPP and Canada employment credits that result from the payment of salary are included in this analysis.

15-150. With this amount of taxes payable, Ms. Olney's after tax retention would be calculated as follows:

| | |
|---|---|
| Salary Received | $95,344 |
| Employee's CPP Contribution - Maximum | ( 2,749) |
| Personal Tax Payable | ( 47,865) |
| After Tax Cash Retained | $44,730 |

15-151. This more realistic result provides considerably less cash than the $49,000 [($100,000)(1 - 0.51)] that was left when CPP, payroll taxes and the Canada Employment credit are ignored. Note, however, while they would not be easy to quantify, the payment of CPP does provide the owner/manager with future benefits. Using the numbers in Paragraph 15-55, this makes payment of salary, if these additional factors are considered, less desirable than dividends paid out of:

- income eligible for the small business deduction (retention was $48,675),
- business income ineligible for the small business deduction (retention was $45,760).

## Exercise Fifteen - 9

**Subject:** Salary And Dividend Compensation

For the year ending December 31, 2019, Broadmoor Inc., a Canadian controlled private corporation has Taxable Income, before consideration of dividends or salary paid to its sole shareholder, of $550,000. All of this income is from active business activities. The cash balance of the Company, prior to any payments on the current year's taxes, is also equal to this amount. The Company makes the maximum eligible dividend designation each year. Its only shareholder, Ms. Sarah Broad, has no income other than dividends or salary paid by the corporation and has combined federal/provincial personal tax credits of $5,000.

In her province of residence, assume:

- the corporate tax rate is 3 percent on income eligible for the small business deduction and 14 percent on other income
- her combined federal/provincial Tax Payable totals $75,000 on the first $210,371 with additional amounts of income taxed at a combined federal/provincial rate of 51 percent
- the dividend tax credit is 30 percent of the gross up for all dividends
- there is no payroll tax

Determine the amount of after tax cash that Ms. Broad will retain if (1) the maximum salary is paid by the corporation out of the available cash of $550,000 and (2) the maximum amount of eligible and non-eligible dividends are paid. Ignore the required CPP contributions and the Canada employment tax credit.

**SOLUTION available in print and online Study Guide.**

### Use Of Tax Credits

15-152. Our example in this section has involved an individual with other sources of income that placed her in the maximum federal tax bracket. This amount of income would generally be sufficient to absorb any tax credits available to the individual. However, there may be situations where a salary vs. dividend decision is being made with respect to an individual with no other source of income. This would be a fairly common situation when a corporation is being used for income splitting purposes, or for a corporation with only a limited amount of income to distribute.

15-153. If the individual has no other source of income and provincial tax rates favour the use of dividends, there may be a problem with the full use of available tax credits. We noted earlier in this Chapter that dividend payments use up tax credits at a much lower rate than other types of income, such as salary. If only limited amounts of income are being distributed, the use of dividends may leave a portion of the individual's tax credits unused. When this is the case, some combination of salary and dividends may provide the optimum solution.

15-154. A further potential complication stems from the fact that provincial tax credits can only be deducted against the provincial tax liability and federal tax credits can only be deducted against the federal tax liability. In our examples and problems we have not taken this into consideration and have given a single figure for combined federal/provincial tax credits.

15-155. In the real world, it would be possible to have a situation where an individual would have to pay some federal tax in order to use up all of their provincial tax credits, or alternatively, pay some provincial tax in order to use up all of their federal tax credits. Given this text's focus on federal income taxes, no further attention will be given to this complication of the issue.

15-156. The following example illustrates the salary vs. dividend issue when the full utilization of tax credits is a consideration.

> **EXAMPLE** Mr. Eric Swenson is the sole shareholder of Swenson Sweets, a Canadian controlled private corporation. The Company has a December 31 year end and, for 2019, it has Taxable Income, before consideration of salary or dividends to Mr. Swenson, of $29,500, all of which results from active business activities. This amount is available in cash, prior to the payment of any salary or dividends. Mr. Swenson has combined federal/provincial personal tax credits of $3,920.
>
> The corporation operates in a province with a corporate tax rate on active business income of a CCPC of 3 percent and no payroll taxes. The provincial tax rate on personal income is 10 percent of the first $47,630 of Taxable Income, with a provincial dividend tax credit on non-eligible dividends that is equal to 4/13 of the gross up. In solving this problem, we will ignore CPP contributions and the Canada employment tax credit.

15-157. If the full $29,500 is paid out in salary, corporate Taxable Income would be nil and there would be no corporate tax payable. Mr. Swenson's after tax cash retention would be as follows:

| | | |
|---|---|---|
| Salary Received | | $29,500 |
| Personal Tax Payable | | |
| Personal Taxes At 25% (15% + 10%) | ($7,375) | |
| Personal Tax Credits (Given) | 3,920 | ( 3,455) |
| After Tax Cash Retained (All Salary) | | $26,045 |

15-158. As dividends are not tax deductible, corporate tax must be paid prior to any dividend distribution. The combined federal/provincial tax rate would be 12 percent (38% - 10% - 19% + 3%) resulting in corporate taxes of $3,540 [(12%)($29,500)]. This means that the maximum dividend that can be paid will be $25,960 ($29,500 - $3,540). The after tax retention in this case is as follows:

| | |
|---|---|
| Non-Eligible Dividends Received | $25,960 |
| Gross Up Of 15% | 3,894 |
| Taxable Dividends | $29,854 |
| Personal Tax Rate | 25% |
| Personal Tax Payable Before Tax Credits | $ 7,464 |
| Personal Tax Credits (Given) | ( 3,920) |
| Dividend Tax Credit [(9/13 + 4/13)($3,894)] | ( 3,894) |
| Tax Payable ($350 In Unused Credits) | Nil |

| | |
|---|---|
| Non-Eligible Dividends Received | $25,960 |
| Personal Taxes (See Paragraph 15-86 - No Taxes Would Be Paid On This Amount) | Nil |
| After Tax Cash Retained (All Dividends) | $25,960 |

15-159. While the low federal/provincial tax rate on corporations suggests that dividends should be the best alternative, the preceding results do not confirm this view. The problem is that dividend income absorbs available tax credits at a much lower rate than other types of income. The fact that the all dividend solution leaves $350 of unused tax credits suggests that a better solution might be to pay a lesser amount of dividends, plus sufficient salary to absorb these unused credits.

15-160. To investigate this possibility, we need to determine the salary/dividend mix that will fully utilize all of Mr. Swenson's credits. To begin, consider what would happen when we add a $1,000 salary payment to the all dividends case. As the salary will be fully deductible, the after tax cost of making this payment is $880 [($1,000)(1.0 - 0.12)]. As a result, in this type of situation, where the goal is to distribute all of the available corporate income, dividends will only have to be reduced by this $880 per $1,000 of salary increase.

15-161. The resulting increase in taxes payable can be calculated as follows:

| | |
|---|---|
| Increase In Salary | $1,000.00 |
| Decrease In Dividends | ( 880.00) |
| Decrease In Dividend Gross Up [(15%)($880)] | ( 132.00) |
| Decrease In Taxable Income | ($ 12.00) |
| Personal Tax Rate | 25% |
| Decrease In Tax Payable Before Dividend Tax Credit | ($ 3.00) |
| Decrease In Dividend Tax Credit = Increase In Tax Payable [(9/13 + 4/13)($132)] | 132.00 |
| Net Increase In Personal Tax Payable | $ 129.00 |

15-162. This analysis demonstrates that each $1,000 increase in salary results in an increase in personal Tax Payable of $129. Alternatively, this can be stated as an increase in personal Tax Payable of $0.129 for every dollar of increase in salary. This means that to utilize Mr. Swenson's $350 in unused tax credits, he will have to receive salary of $2,713 ($350 ÷ 0.129). This results in the following amount being available for dividends:

| | |
|---|---|
| Corporate Taxable Income Pre-Salary | $29,500 |
| Salary | ( 2,713) |
| Corporate Taxable Income | $26,787 |
| Corporate Tax At 12% | ( 3,214) |
| Available For Dividends | $23,573 |

15-163. When this dividend is paid out to Mr. Swenson, his after tax retention is as follows:

| | |
|---|---|
| Non-Eligible Dividends Received | $23,573 |
| Gross Up Of 15% | 3,536 |
| Taxable Dividends | $27,109 |
| Salary | 2,713 |
| Taxable Income | $29,822 |
| Personal Tax Rate | 25% |
| Personal Tax Payable Before Tax Credits | $ 7,456 |
| Personal Tax Credits (Given) | ( 3,920) |
| Dividend Tax Credit [(9/13 + 4/13)($3,536)] | ( 3,536) |
| Personal Tax Payable (Salary And Dividends) | Nil |

| Comparison | All Salary | All Dividends | Salary And Dividends |
|---|---|---|---|
| Non-Eligible Dividends Received | N/A | $25,960 | $23,573 |
| Salary Received | $29,500 | N/A | 2,713 |
| Personal Tax Payable | ( 3,455) | Nil | Nil |
| After Tax Cash Retained | $26,045 | $25,960 | $26,286 |

15-164. As shown in the preceding calculations, this mix of salary and dividends is such that it utilizes all of Mr. Swenson's tax credits and leaves Tax Payable of nil. This results in a solution that not only improves on the $25,960 that was retained in the all dividend scenario, it also improves on the $26,045 that was retained in the all salary case. It would appear to be the optimum solution for this example where only tax effects are considered.

## *Optimizing A Limited Payment Of Cash*

15-165. A similar analysis could be done if the corporation had limited cash. Assume that, while the corporation in the example (Paragraph 15-156) had Taxable Income of $29,500, it had only $16,000 in cash. To determine the maximum salary that can be paid (X), it is necessary to solve the following equation:

$$X = \$16,000 - [(12\%)(\$29,500 - X)]$$

$$X - 0.12X = [(\$16,000 - (12\%)(\$29,500) = \$14,159$$

15-166. Based on this amount of salary, the amount of after tax cash retained would be calculated as follows:

| | | |
|---|---|---|
| Corporate Cash Before Taxes | | $16,000 |
| Corporate Taxes [(12%)($29,500 - $14,159)] | | ( 1,841) |
| Corporate Cash Available For Salary | | $14,159 |

| | | |
|---|---|---|
| Salary Received | | $14,159 |
| Personal Tax Payable: | | |
| Personal Tax On Salary [(25%)(14,159)] | ($3,540) | |
| Personal Tax Credits (Given) | 3,920 | Nil |
| After Tax Cash Retained ($380 In Unused Credits) | | $14,159 |

15-167. Alternatively, if maximum dividends are paid, the amount of after tax cash retained would be calculated as follows:

| | |
|---|---|
| Corporate Cash Before Taxes | $16,000 |
| Corporate Taxes [(12%)($29,500)] | ( 3,540) |
| Corporate Cash Available For Dividends | $12,460 |
| | |
| Non-Eligible Dividend Received | $12,460 |
| Personal Taxes (See Paragraph 15-86 - No Taxes Would Be Paid) | Nil |
| After Tax Cash Retained | $12,460 |

15-168. It is clear that the salary approach results in a considerably larger after tax retention than the dividend approach. This result would be expected given that the corporate cash was insufficient to utilize the personal tax credits in either approach.

## Exercise Fifteen - 10

**Subject:** Salary vs. Dividends

For the year ending December 31, 2019, Mortell Inc., a Canadian controlled private corporation, has Taxable Income, before consideration of dividends or salary paid to its sole shareholder, of $198,000. The Company's cash balance is over $200,000. It is subject to a combined federal/provincial tax rate of 12 percent. Ms. Mortell, the Company's only shareholder, has employment income of $150,000 and, under normal circumstances, does not make withdrawals from the corporation. However, she needs an additional $30,000 in cash to create the home theatre of her dreams. Ms. Mortell's combined federal/provincial tax rate on additional income is 45 percent. She lives in a province where the provincial dividend tax credit is equal to 25 percent of the dividend gross up for non-eligible dividends. She has asked your advice as to whether the payment of salary or, alternatively, the payment of non-eligible dividends, would have the lowest tax cost. Provide the requested advice.

## Exercise Fifteen - 11

**Subject:** Salary vs. Dividends - Limited Corporate Cash

For the year ending December 31, 2019, Fargo Ltd. has Taxable Income, before consideration of dividends or salary paid to its sole shareholder, of $21,500. The Company's cash balance, prior to the payment of any taxes for the year is $18,500. The Company's Taxable Income is subject to a combined federal/provincial tax rate of 12 percent. There is no payroll tax in this province.

Mr. Fargo, the Company's president and sole shareholder, is 71 years of age and has no other source of income (he is not eligible for OAS). He has combined federal/provincial personal tax credits of $3,950 and lives in a province that has a personal tax rate on the first $47,630 of Taxable Income equal to 10 percent. The provincial dividend tax credit is 30 percent of the gross up for non-eligible dividends.

Mr. Fargo would like to remove all of the cash from the corporation and has asked your advice as to whether it would be better to take it out in the form of all non-eligible dividends or all salary. As Mr. Fargo is over 70 years old, no CPP contributions are required. Ignore the Canada employment tax credit. Provide the requested advice.

**SOLUTIONS available in print and online Study Guide.**

## Conclusion

15-169. As the preceding discussion makes clear, the salary vs. dividend decision is complex. Determination of the total tax consequences of the two alternatives does not necessarily resolve the issue. In addition to important factors already discussed in the chapter such as income splitting and bonusing down, consideration should be given to:

- the administrative costs related to withholding and remitting income tax and CPP premiums when salary is paid
- the ability to defer personal taxation to the subsequent calendar year if the payment of salary is deferred and the corporation's year end is within 180 days of December 31
- the effect of the gross up on dividends if the OAS clawback is relevant
- if the owner-manager is applying for a mortgage or loan, it will be more advantageous to have a history of salary received rather than dividends received

15-170. The preceding material does not give you a comprehensive approach to solving these problems on a quantitative basis. In actual fact, there are problems here that are probably not subject to quantitative solutions. For example, whether or not an individual feels a need for retirement income involves many subjective considerations. With an issue such as this, a tax advisor can only outline the various possible outcomes.

**We suggest you work Self Study Problems Fifteen-9 to 11 at this point.**

**Additional Supplementary Self Study Problems Are Available Online.**

# Key Terms Used In This Chapter

15-171. The following is a list of the key terms used in this Chapter. These terms, and their meanings, are compiled in the Glossary located at the back of the Study Guide.

| | |
|---|---|
| Active Business Income | Low Rate Income Pool (LRIP) |
| Aggregate Investment Income | Manufacturing And Processing Profits Deduction (M&P Deduction) |
| Annual Business Limit | Over Integration |
| Bonusing Down | Private Corporation |
| Canadian Controlled Private Corporation | Public Corporation |
| Charitable Donations Tax Credit | Specified Employee |
| Eligible Dividends | Tax Avoidance |
| Estate Planning | Tax Deferral |
| General Rate Income Pool (GRIP) | Tax Planning |
| Income Splitting | Taxable Benefit |
| Integration | TOSI (Tax On Split Income) |
| Lifetime Capital Gains Deduction | Under Integration |
| Limited Liability | |

# References

15-172. For more detailed study of the material in this Chapter, we refer you to the following:

| | |
|---|---|
| ITA 6(1) | Amounts To Be Included As Income From Office Or Employment |
| ITA 15(1) | Benefit Conferred On Shareholder |
| ITA 15(2) | Shareholder Debt |
| ITA 18(1) | General Limitations (On Deductions) |
| ITA 20(1)(j) | Repayment Of Loan By Shareholder |
| ITA 67 | General Limitation Re Expenses |
| ITA 80.4 | Loans - Imputed Interest |
| ITA 80.5 | Deemed Interest |
| ITA 82(1) | Taxable Dividends Received |
| ITA 121 | Deduction For Taxable Dividends |
| ITA 123 To 125.5 | Rules Applicable To Corporations |
| ITA 146 | Registered Retirement Savings Plans |
| ITA 147 | Deferred Profit Sharing Plans |
| S3-F6-C1 | Interest Deductibility |
| IT-67R3 | Taxable Dividends From Corporations Resident In Canada |
| IT-119R4 | Debts Of Shareholders And Certain Persons Connected With Shareholders |
| IT-124R6 | Contributions To Registered Retirement Savings Plans |
| IT-307R4 | Spouse Or Common-Law Partner Registered Retirement Savings Plans |
| IT-421R2 | Benefits To Individuals, Corporations And Shareholders From Loans Or Debt |
| IT-432R2 | Benefits Conferred On Shareholders |
| IT-487 | General Limitation On Deduction Of Outlays Or Expenses |

# Problems For Self Study (Online)

To provide practice in problem solving, there are Self Study and Supplementary Self Study problems available on MyLab Accounting.

Within the text we have provided an indication of when it would be appropriate to work each Self Study problem. The detailed solutions for Self Study problems can be found in the print and online Study Guide.

We provide the Supplementary Self Study problems for those who would like additional practice in problem solving. The detailed solutions for the Supplementary Self Study problems are available online, not in the Study Guide.

The .PDF file "Self Study Problems for Volume 2" on MyLab contains the following for Chapter 15:

- 11 Self Study problems,
- 5 Supplementary Self Study problems, and
- detailed solutions for the Supplementary Self Study problems.

# Assignment Problems

(The solutions for these problems are only available in the solutions manual that has been provided to your instructor.)

### *Assignment Problem Fifteen - 1*

***(Advantages Of Incorporation)***

Philip Caron is in his mid-fifties and he is married with two teen aged children. For over fifteen years, he has worked as an unincorporated welder. The business is currently netting approximately $250,000 per year. In recent years, Mr. Caron has been using about half of the business earnings for personal living expenses.

In the last five years, he has been refining a fork lift which can be attached to half-ton trucks. He has a product which is selling well with few malfunctions and he is in the process of patenting the design. As a result, his welding business is now predominantly manufacturing these fork lift units.

Some of his welding equipment is old and he is faced with the need to replace it. Also, he needs to acquire larger welders and pipe benders to mass manufacture the fork lift. The business expansion will require substantial capital investment for which external financing will be required.

**Required:** Briefly discuss whether Mr. Caron should incorporate his business.

### *Assignment Problem Fifteen - 2*

***(Example Of Integration)***

One of your long-standing clients, Mr. Carson Jones, has operated a successful unincorporated business for 10 years. This business is something of a sideline for him in that he has employment and investment income of over $250,000 per year. Further, these latter sources of income are more than adequate to meet his personal needs and absorb all of his available tax credits.

However, he has an intense dislike for paying taxes, particularly since the government has increased the top federal tax rate to a near obscene (in his opinion) 33 percent. When this maximum federal rate is combined with the top rate of 20 percent in his province, the result is an overall rate of 53 percent.

Given this, he is looking for ways to save taxes. One approach that he would like to consider is transferring the income from his business, as well as a group of publicly traded securities, to a new corporation. The new corporation would be named Carjon Ltd.

He has asked your advice on this approach and, to assist you in providing this advice, he has provided you with the following relevant data:

| | |
|---|---|
| Taxable Income of business (Active Business Income) | $115,000 |
| Eligible portfolio dividends | 133,000 |
| Federal corporate tax rate after federal abatement | 28% |
| Federal Small Business Deduction | 19% |
| General Rate Reduction | 13% |
| Provincial rate on Active Business Income of CCPCs | 2% |
| Provincial dividend tax credits on: | |
| Eligible dividends | 40% of dividend gross up |
| Non-eligible dividends | 23% of dividend gross up |

**Required:**

A. Assume no corporation is used and the income is received directly. Calculate Carson's personal Tax Payable, showing separately the Tax Payable on the active business income and the dividends.

B. Assume the income and dividends are received by Carjon Ltd. Calculate corporate Tax Payable, after tax income available for distribution, and personal taxes that would be payable on the distribution. Your calculations should show separately the Tax Payable on the active business income and any eligible or non-eligible dividends.

C. Compare the Tax Payable with and without the use of Carjon Ltd. and explain why the Tax Payable amounts are different. Advise Carson as to whether he should make the proposed transfers to a new corporation.

### *Assignment Problem Fifteen - 3*

#### *(Flow Through Of Interest Income)*

As an employee of a public company, Maxine Ashley has an annual salary of $155,000.

After years of purchasing losing tickets, Maxine wins $500,000 in the provincial lottery. As her employment income is more than adequate for her current needs, she plans to invest all of these winnings in a debt security for the year ending December 31, 2019. The security pays annual interest at a rate of 5 percent.

The following information is applicable to the province in which Maxine is a resident:

- The provincial marginal tax rate for Maxine is 13 percent.
- The provincial dividend tax credit on non-eligible dividends is 28 percent of the gross up.
- The provincial tax rate on the investment income of CCPCs is 12 percent.

Other than the interest earned on her investment in the debt security, Maxine has no other source of investment income.

**Required:** Prepare calculations that will compare the after tax retention of income that will accrue to Maxine for 2019 if:

A. The investment is owned by her as an individual.

B. The investment is owned by a CCPC in which she is the sole shareholder, and which pays out all available income in dividends.

### Assignment Problem Fifteen - 4

#### (Flow Through Of Dividend Income)

As an employee of a public company, Thomas Nance has an annual salary of $300,000.

After years of purchasing losing tickets, Thomas wins $650,000 in the provincial lottery. As his employment income is more than adequate for his current needs, he plans to invest all of these winnings in public company preferred shares for the year ending December 31, 2019. These securities pay eligible dividends of 6 percent each year.

The following information is applicable to the province in which Thomas is a resident:

- The provincial marginal tax rate for Thomas is 19 percent.
- The provincial dividend tax credit on eligible dividends is 22 percent of the gross up.
- The provincial tax rate on the investment income of CCPCs is 11 percent.

Other than the preferred share dividends, Thomas has no other source of investment income.

**Required:** Prepare calculations that will compare the after tax retention of income that will accrue to Thomas in 2019 if:

A. The investment is owned by him as an individual.

B. The investment is owned by a CCPC in which he is the sole shareholder, and which pays out all available income in eligible dividends.

### Assignment Problem Fifteen - 5

#### (Incorporation Of Investment Income)

The following information provides tax information for the province in which Jason Tegue lives for 2019:

- The combined federal and provincial corporate tax rate on the investment income of CCPCs is 50-2/3 percent (including the ART).
- The provincial dividend tax credit on eligible dividends is equal to 40 percent of the gross up on these dividends.
- The provincial dividend tax credit on non-eligible dividends is equal to 30 percent of the gross up on these dividends.
- Provincial tax payable on an individual's first $95,259 of Taxable Income is $12,817. Amounts in excess of this are subject to provincial tax at a rate of 17.4 percent.

Jason owns the following investments, and anticipates the following Canadian source income for 2019:

| | Value At 31/12/2018 | Type Of Income | Expected Income For 2019 |
|---|---|---|---|
| Powor Corp Bonds | $ 78,000 | Interest | $ 8,600 |
| Larch Company Shares | 312,000 | Dividends | 17,400 |
| Inbridge Inc. Shares | 36,000 | Capital Gains | 6,200 |
| Calgary Dominion Bank Shares | 38,000 | Dividends | 3,600 |
| Calgary Dominion Bank Shares | | Capital Gains | 2,800 |
| Totals | $464,000 | N/A | $38,600 |

Jason only invests in the shares and debt of large, publicly traded companies. He does not own more than 1 percent of the shares or debt in any of these corporations. All of the dividends received were designated as eligible by the paying corporation.

In 2019, in addition to the above investment income, Jason expects to earn $92,000 in employment income. He has combined federal/provincial personal tax credits of $3,491. The total adjusted cost base for his investments is $450,000.

Jason asks you whether it is financially more attractive for him to have his investments owned by a corporation or to own them directly, as he currently does. Assume that he and his investments will generate the anticipated amounts of income.

Jason's lifestyle requires him to use all available income. As a consequence, he would like you to assume that, if the investments are transferred to his corporation, the corporation will pay out all available funds as dividends.

**Required:** Provide an appropriate analysis for Jason Tegue.

### Assignment Problem Fifteen - 6

#### (Partner As Individual Or Corporation)

Having worked as an individual management consultant, Mellisa Fox has enjoyed a great deal of success. Her effectiveness has generated a fairly long list of potential clients who would like to use her services. Recognizing the opportunities involved in this situation, Mellisa has decided to join Consulting Unlimited (CU) as a fourth partner.

Her entrance into the partnership will be effective January 1, 2019. She is giving consideration to three different approaches, the first two of which require the establishment of a new Canadian controlled private corporation (CCPC) in which she will be the sole shareholder. If she adopts one of these alternatives, the other partners in CU have agreed to allocate 25 percent ($125,000) of the small business deduction annual limit to her corporation.

**Alternative 1** Her new corporation will pay corporate tax on its full share of the partnership income, with the after tax funds being paid to Mellisa as dividends.

**Alternative 2** Mellisa will receive sufficient salary from her corporation to reduce the corporation's income to its $125,000 share of the annual business limit. Corporate taxes will be paid on the remaining Taxable Income.

**Alternative 3** Mellisa will join the partnership as an individual. Her share of the partnership income will be taxed as business income.

Mellisa lives in a province where the provincial tax payable on the first $210,371 of Taxable Income is $22,150, with additional amounts being taxed at a provincial rate of 18 percent. In this province, the provincial dividend tax credit is equal to 40 percent of the gross up for eligible dividends and 30 percent of the gross up for non-eligible dividends. Mellisa's tax credits for 2019 total $4,241.

If she forms a new corporation it would be subject to a combined federal/provincial tax rate on income eligible for the small business deduction of 12.5 percent. The rate on other active business income would be 27 percent.

During the CU's taxation year ending December 31, 2019, it is expected to have Taxable Income of $930,000. All of this income will be active business income and Mellisa or her corporation will be entitled to 25 percent of the total.

Because she has no other source of income, she requires all of the income that is generated by her participation in CU.

**Required:** Calculate the after tax personal retention of Mellisa's share of the partnership income for each of the three approaches. Ignore CPP considerations and the Canada employment tax credit in your calculations. Which approach would you recommend? Briefly explain why this alternative is the best and any other factors she should consider.

### Assignment Problem Fifteen - 7

#### (Shareholder Loans)

Borsa Ltd. is a Canadian controlled private corporation with a taxation year that ends on December 31. All of the Company's shares are owned by Derek Borsa. In addition to being the sole shareholder of the Company, Derek works on a full time basis in the business.

Having grown up in a relatively poor working class family, Derek has always exhibited a strong sense of social responsibility. This is reflected in the policies of his Company which provides a generous package of benefits to its employees. Included in these benefits is the provision of interest free loans to employees who have at least 12 months service. Specifically, the Company will provide an interest free loan:

- of up to $150,000 to assist an employee in acquiring a residence. The principal amount of the loan must be repaid the earlier of 5 years from the day the loan was granted and the last day of employment.
- of up to $25,000 to assist an employee in acquiring an automobile to be used in employment related activities. The principal amount of the loan must be repaid the earlier of 3 years from the day the loan was granted and the last day of employment.

Derek borrows from the Company on a regular basis for various reasons. During the year ending December 31, 2019, Derek received loan proceeds from the Company as follows:

1. On February 1, Derek borrows $50,000 to cover a medical procedure on his shoulders in the United States. Derek would have had to wait over 18 months to have this procedure done in Canada while suffering a great deal of pain. As he feels Borsa Ltd. benefits from his increased productivity after the procedure, the loan is interest free and will be repaid on September 30, 2020.
2. On April 1, Derek borrows $15,000 from the company to finance a week at a luxurious resort in British Columbia to please his new wife. The loan will be repaid on December 31, 2019. Because he does not want to appear to his employees to be taking advantage of company funds, he decides that he should pay interest at the market rate for such loans. Assume the relevant rate is currently 5 percent.
3. On June 1, Derek borrows $150,000 in order to purchase a new residence. The loan is interest free. The loan will be repaid in two annual instalments of $75,000, on February 28, 2020 and 2021.
4. On August 1, Derek borrows $50,000 in order to complete the renovations and landscaping of his new residence. The loan is interest free and will be repaid on July 31, 2021.
5. On November 1, to fulfill a lifelong dream, he borrows $212,000 from the Company to purchase a Mercedes S Class sedan. As it will be used purely for personal activities, he does not qualify for the $25,000 interest free loan. The loan bears interest at an annual rate of 1 percent and will be repaid on May 1, 2022.

All repayments and interest payments are made as scheduled. In all of the years under consideration, assume the relevant prescribed rate is 2 percent.

**Required:**

A. Indicate the tax consequences that will accrue to Derek as a result of receiving these loans. Briefly explain your conclusions for each loan for the years it is outstanding. Base your interest calculations on the number of months the loans are outstanding.

B. Identify any tax planning issues that are associated with these loans.

### Assignment Problem Fifteen - 8

#### (Bonusing Down)

Donat Ltd. is a Canadian controlled private corporation (CCPC) that anticipates that its Taxable Income for the taxation year ending December 31, 2019 will be $625,000. All of the Corporation's shares are owned by Martin Donat. The anticipated income figure of $625,000 is after the deduction of a $275,000 salary payment to Martin. He plans to maintain his salary at $275,000 for the next 5 years.

All of Donat Ltd. income, both in the current and in previous years, is the result of active business income. However, this is the first year that its Taxable Income has exceeded the annual business limit for the small business deduction. It has no balance in its GRIP account at the beginning of 2019.

Martin has read an article written by a financial expert which states that when the Taxable Income of a CCPC exceeds $500,000 you must "bonus down" to prevent double taxation.

He does not need any additional funds for his personal living costs currently, but plans to build his dream home in 2023. That year, he will require substantial cash for the home's construction.

In Martin's province of residence, assume:

- for 2019 that provincial corporate tax rates are 13 percent on active business income in excess of the small business deduction and 2.5 percent on active business income eligible for the small business deduction.
- for 2019 to 2023 any Taxable Income in excess of Martin's $275,000 salary will be taxed at 33 percent federally and 19 percent provincially
- for 2023 the dividend gross up will be 38 percent for eligible dividends and 15 percent for non-eligible dividends
- for 2023 the federal dividend tax credit will be 6/11 of the gross up for eligible dividends and 9/13 of the gross up for non-eligible dividends
- for 2023 the provincial dividend tax credit will be 36 percent of the gross up for eligible dividends and 20 percent of the gross up for non-eligible dividends

**Required:** As Martin's tax consultant would you advise him to bonus down by paying himself additional salary of $125,000 in 2019? Justify your conclusion.

### Assignment Problem Fifteen - 9

#### (Salary Vs. Dividends - Required Amount)

Lara Collins is the sole shareholder of Collins Inc., a Canadian controlled private corporation. It uses a December 31 taxation year.

All of its income qualifies for the small business deduction. This income is allocated to a province where the provincial rate on this type of income is 3 percent.

Lara needs an additional $30,000 in cash in order to create a much needed woman cave in her basement. Collins Inc. has sufficient cash to pay either additional salary or additional dividends in order to provide the required funds. The Company has no balance in its GRIP account.

Lara's 2019 Taxable Income, before consideration of any additional payment from Collins Inc., is $98,000. This includes salary of $75,000 from Collins Inc. In the province where she is resident, the provincial tax rate on Taxable Income over $95,259 is 12 percent. The dividend tax credit for non-eligible dividends in this province is 30 percent of the dividend gross up.

**Required:** Determine the amount that would be required in the way of salary and in the way of dividends, in order to provide Lara with the required after tax funds of $30,000. Which alternative would have the lowest tax cost to Lara and her corporation?

### Assignment Problem Fifteen - 10

#### (Salary Vs. Dividends - Required Amount)

Simon Fahrquest is the sole shareholder of Dawg Ltd., a very successful business that was incorporated a number of years ago. The Company has always qualified as a CCPC and uses a December 31 year end.

Simon has never been particularly fond of people, but has always loved dogs, particularly those of mixed breed. While he has no family, he currently owns 12 dogs, none of which are purebred.

While Dawg Ltd. has always been very profitable, Simon has chosen to live modestly in a dog friendly residential property that he has owned for many years. Each year, he estimates the amount of cash that he will need for his living expenses which vary year to year and looks to his corporation to provide the needed cash.

Since after meeting Simon's financial needs, Dawg Ltd. always has cash that isn't required for operations, it donates at least $100,000 per year to the Society For The Prevention Of Cruelty To Animals (SPCA), a registered charity. The donations specify that the funds must be used for the protection, maintenance, and placement of mixed breed dogs.

For 2019, Simon estimates that he will need $50,000 in after tax cash to meet his personal needs. He expects Dawg Ltd. will have Taxable Income of $350,000 before any payments to him, all of which will qualify for the small business deduction. The provincial tax rate on such income is 3 percent.

In Simon's province of residence, the provincial taxes on the first $47,630 of Taxable Income total $4,528. Additional income will be taxed at a provincial rate of 12 percent. Also in this province, the provincial dividend tax credit for non-eligible dividends is equal to 32 percent of the dividend gross up.

For the 2019 taxation year, Simon estimates that his personal tax credits will total $3,260.

**Required:**

A. Determine the tax cost of providing Simon with the required $50,000 in after tax cash using only salary payments.

B. Determine the tax cost of providing Simon with the required $50,000 in after tax cash using only dividend payments.

C. Given the information in this problem, do you believe that better results could be achieved with a combination of salary and dividends? Would your answer be different if Simon's personal tax credits totalled $10,000 instead of $3,260? Calculations are not required in answering this Part C.

D. Simon would like to increase his donations to the SPCA and has asked your advice on the most tax advantageous way to do this. What factors should be considered when analyzing this issue?

Ignore CPP contributions and the Canada employment credit in your solution.

### Assignment Problem Fifteen - 11

#### (Salary Vs. Dividends - Optimum Mix)

Robert Lorca is the only shareholder of Rolorc Ltd., a Canadian controlled private company with a taxation year that ends on December 31. His only source of income is either dividends or salary provided by Rolorc. For 2019, because of extensive medial costs, he has available tax credits of $9,500.

While Rolorc's 2019 taxable income before any salary or dividend payments is $185,000, large capital expenditures has left the Company with only $89,000 in cash that is available for distribution.

Relevant information with respect to Robert's province of residence is as follows:

- In order to simplify calculations, assume that all of Robert's Taxable Income will be taxed at a combined federal/provincial rate of 24 percent.
- The provincial dividend tax credit is equal to 33 percent of the gross up on non-eligible dividends.
- All of the company's activities are confined to a province in which the applicable corporate rate of taxation is 3 percent on income eligible for the small business deduction. The province does not levy a payroll tax.

**Required:** Ignore the required CPP contributions and the Canada employment tax credit when answering Parts A to D in this problem.

A. Determine the after tax amount of cash that Robert will retain if all of the Company's cash is used to pay taxes and salary.

B. Determine the after tax amount of cash that Robert will retain if the Company pays the maximum possible dividend.

C. Can Robert improve his after tax cash retention by using a combination of salary and dividends? Explain your conclusion.

D. If your answer to Part C is positive, determine the combination of salary and/or dividends that will produce the maximum after tax cash retention for Robert. Calculate the amount of this after tax cash retention.

# CHAPTER 16

# Rollovers Under Section 85

## Rollovers Under Section 85

### Introduction

16-1. Chapter 15 gave detailed consideration to the question of whether it would be advantageous to establish a corporation in order to reduce, defer, or redistribute the amount of Tax Payable. If the results of this analysis favour the use of a corporation, Section 85 of the *Act* provides an attractive basis for the transfer of property to the new corporation.

16-2. The problem that is involved with such a transfer is that the assets may have been owned by the transferor for some period of time. In these circumstances, it is possible that their fair market values may be well in excess of their adjusted cost base and/or their undepreciated capital cost. As a transfer by a taxpayer to a corporation would be considered a disposition by that taxpayer, the incorporation of an existing business could result in a need to include both capital gains and recapture in the transferor's Taxable Income. In a typical situation, where the owner of an operating business decides to transfer all of its assets to a newly formed corporation, the resulting tax liability could be significant.

> **EXAMPLE** Joanne Browski has an unincorporated business that is using assets with a fair market value of $572,000. The tax values for these assets total $225,000. Ms. Browski would like to transfer these assets to a corporation and continue her operations in that legal form (note, that while we have treated the group of assets like a single asset in order to simplify this example, in actual practice, each asset would have to be treated individually).
>
> **ANALYSIS** Under the general tax rules, asset dispositions must be recorded at fair market value. If this applied to Ms. Browski's transfer, the amount of taxation would be significant and could be a deterrent to the incorporation of her business.

16-3. Section 85 of the *Income Tax Act* is designed to provide relief in this type of situation. In somewhat simplified terms, it permits Ms. Browski's property to be transferred to a corporation on either a tax free basis, or with a level of taxation that is determined at her discretion. As noted in earlier Chapters, such transactions are referred to in tax work as rollovers.

16-4. Of the rollovers that are available, the content of Section 85 provide for one of the most important and widely used. In this Chapter we will provide detailed coverage of the application of this Section. Other rollovers involving corporations will be given coverage in Chapter 17.

# General Rules For The Transfer

## Transferor And Transferee

### Transferors

16-5. As indicated in the introduction, we are concerned here with transfers of property to a corporation at a value that can be elected by the transferor and the corporation. There are several possibilities with respect to the identity of the transferor:

- The transferor may be an **individual** who wishes to incorporate his proprietorship.
- The transferor may be a **corporation** that wishes to transfer some of its assets to a different corporation.
- The transferor may be a **trust** that wishes to transfer some of its assets to a corporation.
- The transferor may be a **partner** who wishes to incorporate his partnership interest.

16-6. ITA 85(1) refers to taxpayers and this subsection covers the rules related to transferors who are individuals, corporations, and trusts. As partnerships are not "taxpayers" for income tax purposes, a separate ITA 85(2) provides for the transfer of partnership assets to a corporation.

### Transferees

16-7. With respect to transferees, Section 85 requires that they be taxable Canadian corporations. A "Canadian corporation" is defined in ITA 89(1) as a corporation that is currently resident in Canada and that was either incorporated in Canada, or has been a resident continuously since June 18, 1971. ITA 89(1) also defines a "taxable Canadian corporation" as a Canadian corporation that was not, by virtue of a statutory provision, exempt from taxation under Part I of the *Income Tax Act*.

## Eligible Property

16-8. Only "eligible property", the components of which are defined in ITA 85(1.1), can be transferred under Section 85. The major items listed in the Subsection include:

- both depreciable and non-depreciable capital property, generally not including real property owned by non-residents;
- Canadian resource properties;
- foreign resource properties;
- inventories, other than inventories of real property; and
- real property owned by a non-resident person and used in the year in a business carried on by that person in Canada.

16-9. The general exclusion of real property owned by non-residents reflects the fact that this type of property is Taxable Canadian Property and gains on its disposition are subject to Canadian taxes, without regard to the residency of the seller. The exclusion is designed to prevent a non-resident who owns Canadian real estate from being able to transfer the property on a tax free basis to a corporation, and subsequently selling the shares in the corporation on a tax free basis. As explained in Chapter 20, gains on such dispositions are typically exempted from Canadian tax by international tax treaties.

16-10. The second exclusion from assets eligible for the Section 85 rollover would be Canadian resident owned real property that constitutes an inventory. That is, if a group of real property assets is being actively traded, rather than being held for their income producing ability, they are not eligible for a tax free rollover under ITA 85.

16-11. This latter exclusion of inventories of real property can be a particularly troublesome provision due to the fact that, in practice, some taxpayers may not be certain as to the status of their real estate holdings. If a taxpayer was to go through the Section 85 rollover procedures and then, after the fact, find that the transferred real estate holdings were considered inventory by the CRA, the tax consequences would be very severe. In this type of situation, it would be advisable to delay the transfer to the corporation until such time as any uncertainty regarding the status of the real estate could be clearly established.

## Consideration To Transferor

16-12. In return for the property transferred to the corporation, the corporation may provide various types of consideration to the transferor. The one requirement that is specified in ITA 85(1) is that some part of this consideration must consist of shares of the transferee corporation.

16-13. The shares issued may be either preferred, common, or some combination of the two types. Further, the requirement for share consideration to be used can be satisfied by the issuance of as little as one share to the transferor. For reasons that will become evident later in this Chapter, the usual Section 85 transaction involves the use of a combination of shares and non-share consideration (e.g. cash or debt securities). In this context, the non-share consideration is usually referred to as the "boot".

16-14. A further point here is that, without regard to the values that are elected for the exchange, the fair market value of the consideration provided to the transferor should be equal to the total fair market value of the assets transferred to the corporation. As will be discussed later in this Chapter, if these amounts are not equal, the difference may be viewed as a benefit to the transferor, or a gift to a related party.

## Making The Election

16-15. Both the transferor and the transferee corporation must elect to have the Section 85 provisions apply. This joint election is accomplished by filing Form T2057 (transfers from individuals, trusts, and corporations) or T2058 (transfers from partnerships), on or before the earliest of the dates on which the normal tax returns are due for the two taxpayers.

16-16. A late election may be filed for up to three years after this date and, with the permission of the CRA, a late election will be accepted after the end of this three year period. Whenever there is a late election, a penalty of one-quarter of 1 percent of any capital gain or other income will be assessed for each month beyond the normal filing date. The maximum penalty is $100 per month to a maximum of $8,000.

16-17. In making the election, it is crucial that the taxpayer list all of the properties that are to be covered. If a property is omitted from the forms, the normal rules associated with dispositions will apply. This could result in the need to recognize capital gains, recapture, or business income on the transfer, an outcome that might require needless payment of taxes.

## Establishing The Transfer Price

### *Importance*

16-18. One of the most significant features of ITA 85 is that it provides for the transfer of various properties to a corporation at values that are jointly elected by the transferor and transferee. Careful consideration must be given to the election of an appropriate transfer price in that, in general, this elected value establishes three important values. These are:

**Transferor** The deemed proceeds of disposition for the property given up.

**Transferor** The adjusted cost base or capital cost of the consideration received from the corporation.

**Transferee** The tax cost of the property received by the corporation (adjusted cost base, capital cost, or UCC).

16-19. As will be discussed at a later point in this Chapter, the elected value is also influential in determining the PUC of the newly issued shares.

### *Basic Rules*

16-20. While there are a number of complications associated with establishing transfer prices, the basic rules are very straightforward. The elected values cannot exceed fair market values and cannot be less than the adjusted cost base of non-depreciable assets, or the UCC of depreciable assets. As we will see in the next section, the floor elected value is also limited by the boot, or non-share consideration, received.

**EXAMPLE** Mr. Thompson owns non-depreciable capital assets with a fair market value of $750,000 and an adjusted cost base of $500,000. On the transfer of these assets to a corporation, he will receive consideration with a fair market value of $750,000. However, under the provisions of ITA 85, the elected value can be any value between a floor of $500,000 and a ceiling of $750,000.

**ANALYSIS** In most situations, the transferor wishes to avoid recognizing income on the transfer and, in order to do this, the elected value will be the floor of $500,000. The election of this value will have the following tax consequences for the transferor and the transferee:

- The $500,000 will be the proceeds of disposition to the transferor. As this is equal to his adjusted cost base for the assets, there will be no capital gain on the transfer.
- The adjusted cost base to the corporation will be $500,000. This means that, if the corporation were to sell the assets immediately for their fair market value of $750,000, a capital gain of $250,000 ($750,000 - $500,000) would have to be recognized. This reflects the fact that the gain on the assets at the time of transfer was only deferred, not eliminated, by the use of the ITA 85 rollover.
- While we have not specified the type of consideration that will be received by the transferor, the election of $500,000 as the transfer price means that the adjusted cost base of the consideration will be this amount. This will be less than the $750,000 fair market value of the consideration.

16-21. You should note that this scenario raises the possibility of double taxation on the $250,000 gain. The adjusted cost base of the property transferred and the consideration received by the transferor is $500,000. If the corporation sells the assets for their fair market value of $750,000, there will be a $250,000 gain at the corporate level. If the consideration received by the transferor is in the form of shares, a sale of these shares at their fair market value of $750,000 would result in the $250,000 gain being taxed a second time at the individual level. This would suggest that, if either the assets transferred, or the consideration received by the transferor are to be sold, the election should be made at the fair market value of $750,000.

### Non-Share Consideration (Boot)

16-22. The term, "boot", is commonly used to refer to non-share consideration given to the transferor in an ITA 85 rollover. It would include cash paid to the transferor and new debt of the transferee corporation issued to the transferor. In those cases where an existing business is being transferred under these provisions, boot would include the assumption by the transferee corporation of any debt of the existing business that is being transferred.

16-23. Other types of non-share consideration (e.g., capital assets) could be used in an ITA 85 rollover and, if this was the case, the term boot would still be appropriate. However, in almost all situations, boot is restricted to cash, new debt issued by the transferee corporation, or existing debt of the transferor assumed by the transferee corporation.

16-24. Boot is of considerable significance in that, if the rollover is properly structured, it constitutes an amount of cash or cash equivalent that will be received by the transferor on a tax free basis. Because of this, the other basic rule on establishing a transfer price is that the elected amount cannot be less than the value of the non-share consideration provided to the transferor.

16-25. The example that was presented in Paragraph 16-20 involved non-depreciable capital assets with an adjusted cost base of $500,000 and a fair market value of $750,000. With respect to the consideration received by Mr. Thompson, assume that it is as follows:

| | |
|---|---|
| Cash | $600,000 |
| Shares Of Transferee Corporation | 150,000 |
| Total (Equals Fair Market Value Of Assets Transferred) | $750,000 |

16-26. Because the elected value cannot be below the value of the non-share consideration, the minimum elected value would be $600,000. If $600,000 was the elected value, it would result in the following tax consequences:

- The proceeds of disposition to the transferor would be $600,000, resulting in a taxable capital gain of $50,000 [(1/2)($600,000 - $500,000)].
- The adjusted cost base of the assets for the corporation would be the transfer price of $600,000. This means that if the corporation sells the assets for their fair market value of $750,000, the capital gain would be $150,000.
- The adjusted cost base of the consideration received by the transferor would be $600,000. As will be discussed at a later point, all of this amount must be allocated to the non-share consideration, leaving the share consideration with a nil adjusted cost base.

### *The Usual Scenario*

16-27. As illustrated in the preceding example, if the boot exceeds the tax values (adjusted cost base or UCC) of the assets transferred, the result is some form of Taxable Income. As one of the usual goals in using ITA 85 is to avoid a tax liability on the transfer of assets, the normal procedure is to set the transfer price at an amount equal to the tax values of the assets and to restrict the use of boot to this value. In the example presented, this would mean using $500,000 as the elected value and paying or issuing non-share consideration in this same amount.

16-28. In addition, the fair market value of the consideration received by the transferor must be equal to the fair market value of the assets transferred to the corporation. In the example presented in Paragraph 16-20, this value is $750,000. This means that if the maximum non-share consideration of $500,000 is used, shares must be issued with a fair market value of $250,000.

16-29. If we apply this scenario to the example presented in Paragraph 16-20, the results would be as follows:

- As the proceeds of disposition would be $500,000, no capital gain would arise on the transfer to the corporation.
- The adjusted cost base to the corporation of the assets acquired will be $500,000.
- The adjusted cost base of the non-share consideration to the transferor would be $500,000. This means that the adjusted cost base of the share consideration would be nil.

16-30. There are a number of complications associated with rollovers under ITA 85 and they will be the subject of much of the remainder of this Chapter. However, the great majority of these transactions will follow the pattern illustrated in the preceding simple example.

# Transfer Prices - Detailed Rules

## Rules Applicable To All Assets

16-31. There are a number of rules in ITA 85 that apply to all types of property. To begin, ITA 85(1)(a) establishes that the amount elected by the taxpayer and corporation shall be deemed to be the taxpayer's proceeds of disposition, as well as the cost of the property to the corporation.

16-32. A further general rule is as follows:

> **ITA 85(1)(b)** Subject to Paragraph 85(1)(c), where the amount that the taxpayer and corporation have agreed on in their election in respect of the property is less than the fair market value, at the time of the disposition, of the consideration therefor (other than any shares of the capital stock of the corporation or a right to receive any such shares) received by the taxpayer, the amount so agreed on shall, irrespective of the amount actually so agreed on by them, be deemed to be an amount equal to that fair market value;

16-33. This establishes that the elected value cannot be less than the boot ("consideration other than shares of stock of the corporation").

16-34. Finally, a further provision limits the elected value to the fair market value of the property transferred:

> **ITA 85(1)(c)** Where the amount that the taxpayer and the corporation have agreed on in their election in respect of the property is greater than the fair market value, at the time of the disposition, of the property so disposed of, the amount so agreed on shall, irrespective of the amount actually so agreed on, be deemed to be an amount equal to that fair market value;

16-35. These general rules apply to all assets transferred, thereby establishing a range for the election. This range can be outlined as follows:

**Ceiling Value** Fair market value of the assets transferred to the corporation.

**Floor Value** The floor value will be equal to the greater of:

- the fair market value of the non-share consideration (boot) given to the transferor in return for the assets transferred; and
- the tax values (adjusted cost base or UCC) of the assets transferred.

16-36. The application of the term, "tax values", in the preceding outline of the rules will vary with the type of asset involved. Attention will be given to these differences in the material which follows.

## Accounts Receivable

16-37. As was discussed in Chapter 6, when accounts receivable are transferred in conjunction with all of the other assets of a business, under the usual rules, the disposition will be treated as a capital transaction, with any resulting loss being only one-half deductible. Further, as the transferee has not included these amounts in income, no deduction can be made for bad debts. If the transferee collects less than the transfer amount, the difference must be treated as a capital loss and again, only one-half of this loss will be deductible.

16-38. To avoid these results, the usual procedure is to use a joint election under ITA 22. This election allows any loss to be treated as a fully deductible business loss and permits the transferee to deduct bad debts after the transfer. You may recall that this election was discussed in Chapter 6. If you do not recall the application of ITA 22, you should review this material now as this election will be commonly used in the problem material in this Chapter.

16-39. While accounts receivable can be transferred under ITA 85, taxpayers are not permitted to elect under both ITA 85 and ITA 22. In general, it will be to the advantage of the taxpayer to make the ITA 22 election and, as a result, accounts receivable will usually not be one of the assets listed in the ITA 85 election.

16-40. Note, however, this does not prevent these assets from being transferred. Using the ITA 22 joint election, they can be transferred at fair market value, with any resulting loss being fully deductible to the transferor. The corporation will have to include the difference between the face value and the price paid in income, but any difference between the face value and the amounts collected will be 100 percent deductible.

## Inventories And Non-Depreciable Capital Property

16-41. Unlike the situation with accounts receivable, when inventories are disposed of in conjunction with the sale of a business, any difference between fair market value and cost is automatically treated as business income or loss, not as a capital gain or loss. This is specifically provided for in ITA 23, with no election being required to bring this provision into effect.

16-42. Non-depreciable capital property of a business would include land, temporary investments, and long-term investments. As capital property is involved, any gain or loss on their disposition would be treated as a capital gain or loss.

16-43. In making the election here, the highest value will be the fair market value of the

assets transferred to the corporation. The minimum election cannot be below the amount of the boot received by the transferor. However, a further floor limit is specified for the inventories and non-depreciable capital property in ITA 85(1)(c.1) to ensure that artificial losses cannot be created. This limit is the lesser of the fair market value of the property and its tax cost. For non-depreciable capital assets, the tax cost would be the adjusted cost base of the property. For inventory, tax cost would be either cost or market, depending on how the inventory balance is carried for tax purposes.

16-44. Putting these limits together means that the minimum elected value for the floor, as specified in ITA 85(1)(e.3), will be the greater of:

A. The fair market value of the boot (the general floor for all assets); and

B. The lesser of:
  - the tax cost of the property; and
  - the fair market value of the property.

16-45. These rules can be illustrated using the three examples that follow:

| | Example One | Example Two | Example Three |
|---|---|---|---|
| Fair Market Value Of Property | $15,000 | $10,000 | $20,000 |
| Adjusted Cost Base | 12,000 | 12,000 | 14,000 |
| Fair Market Value Of The Boot | 5,000 | 5,000 | 17,000 |

16-46. In Example One, the maximum transfer value is the fair market value of $15,000 and the minimum value is the cost of $12,000. The normal election value would be $12,000. Also note that up to $12,000 of boot, an additional $7,000, could have been taken out without changing the minimum election, or creating immediate tax consequences.

16-47. In Example Two, the $10,000 fair market value is both the floor and the ceiling. If the property is inventories, this required election will result in a fully deductible business loss of $2,000 ($12,000 - $10,000). Alternatively, if the election was made on non-depreciable capital property, the result would be an allowable capital loss of $1,000 [(1/2)($12,000 - $10,000)]. As explained beginning in Paragraph 16-50, this capital loss would be disallowed.

16-48. In Example Three, the maximum value is again the fair market value. While the $14,000 cost is lower than the $20,000 fair market value, it is also lower than the boot. This means that, in this example, the minimum value that can be elected is the boot of $17,000. If this property is inventory, this election will result in fully taxable business income of $3,000 ($17,000 - $14,000). If the election was made on non-depreciable capital property, the result will be a taxable capital gain of $1,500 [(1/2)($17,000 - $14,000)].

16-49. If the goal is to structure the rollover to avoid any gain on the transfer of assets, Example Three will not accomplish this objective. In order to avoid a gain, the usual procedure is to limit the non-share consideration to the minimum elected value as otherwise determined, or $14,000 in Example Three.

## Exercise Sixteen - 1

**Subject:** Elected Value For Non-Depreciable Property

Jean Doan's unincorporated business has inventories with a fair market value of $125,000 and a tax cost of $140,000. In addition, he owns land with a fair market value of $350,000 and a tax cost of $110,000. He intends to transfer these assets to a new corporation, taking back $125,000 in cash for the inventories. For the land, he receives $150,000 in cash and $200,000 in securities. If he uses ITA 85 for the transfer, what is the possible range of values that can be elected for the two properties? Assume he elects the lowest possible value in each case. What are the tax consequences for Mr. Doan?

**SOLUTION available in print and online Study Guide.**

## Non-Depreciable Capital Property - Disallowed Capital Losses

### General Rules

16-50. The special rules described in the following material apply only to non-depreciable capital assets. They do not apply to either inventories or depreciable capital assets as it is not possible to have capital losses on these types of assets.

16-51. While we are discussing these rules in the material related to Section 85 rollovers, you should note that they are applicable to transfers to affiliated persons, without regard to whether Section 85 is being used. The discussion is located here because, when a non-depreciable capital asset is transferred under ITA 85, the recognition of a loss may be unavoidable because of the rules limiting the elected values. This was the case in Example Two in Paragraph 16-45.

16-52. The basic rule applicable to these situations is found in ITA 40(2)(g), which indicates that a taxpayer's loss, to the extent that it is a "superficial loss", is deemed to be nil. As with many other concepts related to capital assets, the definition of "superficial loss" is found in ITA 54:

> **"superficial loss"** of a taxpayer means the taxpayer's loss from the disposition of a particular property where
>
> (a) during the period that begins 30 days before and ends 30 days after the disposition, the taxpayer or a person affiliated with the taxpayer acquires a property (in this definition referred to as the "substituted property") that is, or is identical to, the particular property, and
>
> (b) at the end of that period, the taxpayer or a person affiliated with the taxpayer owns or had a right to acquire the substituted property.

16-53. Read together, these provisions deem to be nil any capital loss arising on a transfer to an affiliated person. While the allocation of the loss will depend on whether the transferor is an individual, a trust or a corporation, the denial of the loss is applicable to all taxpayers. The actual allocation of the denied loss will be dealt with after our discussion of affiliated persons.

### Affiliated Persons

16-54. The term "affiliated person" is defined in ITA 251.1(1) as follows:

A. An individual is affiliated to another individual only if that individual is his spouse or common-law partner.

B. A corporation is affiliated with:
   1. a person who controls the corporation;
   2. each member of an affiliated group of persons who controls the corporation; and
   3. the spouse or common-law partner of a person listed in (1) or (2).

C. Two corporations are affiliated if:
   1. each corporation is controlled by a person, and the person by whom one corporation is controlled is affiliated with the person by whom the other corporation is controlled;
   2. one corporation is controlled by a person, the other corporation is controlled by a group of persons, and each member of that group is affiliated with that person; or
   3. each corporation is controlled by a group of persons, and each member of each group is affiliated with at least one member of the other group.

16-55. ITA 251.1(3) contains definitions that are required in the application of these rules. The two that are of importance here are:

> **Affiliated group of persons** means a group of persons each member of which is affiliated with every other member.
>
> **Controlled** means controlled, directly or indirectly, in any manner whatever. This definition refers to both legal control and de facto control, which does not necessarily require majority ownership of all shares.]

16-56. As was previously noted, if a capital loss arises on a transfer to an affiliated person, it is deemed to be nil. This rule applies to all taxpayers, including individuals, trusts, and corporations. In contrast to the normal use of the term, for purposes of the affiliated person rules, the term "person" includes partnerships. You should also note that, for transfers involving ITA 85, the transferee and the transferor will almost always be affiliated (e.g., the transferor will typically control the transferee corporation).

### Allocation Of Disallowed Capital Loss

16-57. When the transferor is an individual, the disallowed loss is allocated to the adjusted cost base of the transferred property. This requirement is dictated by ITA 53(1)(f), which describes adjustments to the cost base of a transferred property.

> **EXAMPLE - Individual** Ms. Hannah Howard, the sole shareholder of HH Ltd., transfers land with an adjusted cost base of $50,000 and a fair market value of $40,000, to HH Ltd. The transfer is made under Section 85 at an elected value of $40,000.
>
> **ANALYSIS** The $10,000 loss ($40,000 - $50,000) on the transfer is disallowed. As the transferor is an individual, the loss will be allocated to the adjusted cost base of the land in the tax records of HH Ltd. This means that the adjusted cost base to HH Ltd. will be the same $50,000 ($40,000, plus the $10,000 loss) that was the adjusted cost base to Ms. Howard.

16-58. When the transferor is a corporation, trust, or partnership, the allocation of the disallowed loss is covered under ITA 40(3.4). In effect, this provision keeps the loss in the tax records of the transferor, to be recognized when one of the following events occurs:

- the transferee disposes of the property to a non-affiliated person (includes deemed dispositions);
- if the transferor is a corporation,
  - it is subject to an acquisition of control; or
  - it is subject to an ITA 88(2) winding up.

> **EXAMPLE - Not An Individual** HC Ltd. transfers land with an adjusted cost base of $50,000 and a fair market value of $40,000 to HCSub, a corporation controlled by HC Ltd., i.e., an affiliated person. Two years later, HCSub sells the land for $35,000 to a non-affiliated person.
>
> **ANALYSIS** The $10,000 ($40,000 - $50,000) loss on the transfer to HCSub will be disallowed at the time of the transfer. However, when the land is sold by HCSub for $35,000, HC Ltd. will recognize the disallowed loss of $10,000 ($50,000 - $40,000). In addition, HCSub will recognize a $5,000 ($40,000 - $35,000) loss at the time of sale. The result is a total loss for the two companies of $15,000 ($50,000 - $35,000).

### Tax Planning

16-59. To the extent that the asset with the unrealized loss is necessary to the continued operations of the business, for example land on which the enterprise's factory is located, it makes no difference whether it is transferred under the provisions of ITA 85 or outside the election. In either case, the loss will be disallowed at the time of the transfer.

16-60. If an asset is not essential to the operations of the corporation, a preferable course of action may be to sell it to a non-affiliated person. This will permit the immediate recognition of any loss on its disposition. However, if the asset is an integral part of the operations of the transferor this is not a viable alternative.

16-61. The other basic point here is, that if the asset in question has an unrealized loss, there is no reason to elect to transfer it under Section 85. The objective that the taxpayer is attempting to achieve in using Section 85 is to defer the taxation of income. When losses are involved on particular assets, including those assets in the Section 85 rollover complicates the election without contributing to the taxpayer's desired goals.

## Depreciable Property

### General Rules

16-62. As with other assets, the ceiling for the election is the fair market value of the asset and the general floor is the fair market value of the non-share consideration received by the transferor. However, as was the case with inventories and non-depreciable capital property, a further lower limit is specified in the *Income Tax Act*.

16-63. ITA 85(1)(e) indicates that for depreciable property, the lower limit is the least of the UCC for the class, the fair market value of each individual property, and the cost of each individual property. This means that the overall lower limit for the election, as specified in ITA 85(1)(e.3), is the greater of:

A. The fair market value of the boot (general floor for all assets), and

B. The least of:

- the balance of the UCC for the class;
- the cost to the taxpayer of each individual property; and
- the fair market value of each individual property.

### Examples - Elected Values

16-64. These rules can be illustrated by the following two examples, each involving the transfer of the only asset in a CCA class:

| | Example One | Example Two |
|---|---|---|
| Fair Market Value Of The Property | $50,000 | $18,000 |
| UCC Of Class (Last Asset In Class) | 20,000 | 20,000 |
| Cost Of The Property | 27,000 | 30,000 |
| Fair Market Value Of The Boot | 15,000 | 15,000 |

**Example One Analysis** In Example One, the range of the election would extend from the UCC of $20,000 as the floor to the fair market value of $50,000. Note that any election in between the UCC of $20,000 and the cost of $27,000 would result in recapture of CCA. The normal election here would be the UCC of $20,000, which results in the transferor not recognizing a capital gain or recapture of CCA. In addition, the transferor would usually take out $20,000 in boot. In Example One, $5,000 more boot could be taken out without creating immediate tax consequences.

**Example Two Analysis** In Example Two, using the limits specified in ITA 85(1)(e.3) the ceiling value and the floor value would be the $18,000 fair market value of the property. With the ceiling and floor at the same value, the general rules would indicate that only this $18,000 value could be elected. In Example Two, $3,000 more boot could be taken out without creating immediate tax consequences. Since the transfer of the property removes the last asset in this CCA class, the fact that the elected value is below the UCC suggests a terminal loss. However, as will be discussed beginning in Paragraph 16-70, ITA 85 does not apply to this transfer and this terminal loss will be disallowed.

### Example - Order Of Disposition

16-65. An additional problem arises in the case of depreciable assets in situations where a number of different assets that belong to the same CCA class are being transferred at the same time. This problem can be illustrated by the following example:

**EXAMPLE** An individual owns two assets in a particular CCA class and the UCC for that class is $28,000. Data on the two assets is as follows:

| | Asset One | Asset Two |
|---|---|---|
| Cost Of Asset | $15,000 | $30,000 |
| Fair Market Value | 20,000 | 25,000 |

16-66. The problem here is that the wording of the transfer price rules for depreciable assets requires the floor to be based on the least of the cost of each individual asset, fair market value of each individual asset, but UCC for the class as a whole. This determination has to be made with respect to each asset in the class, with the resulting figures summed for purposes of the election floor.

16-67. This means that, if the general rules were applied, the floor values would be $15,000 for Asset One, plus $25,000 for Asset Two. This reflects the fact that both of these individual values are less than the $28,000 UCC for the class. However, if these values are elected, a total of $40,000 would be subtracted from the class. Since the UCC balance for the class is only $28,000, this would result in recapture of $12,000.

16-68. To alleviate this problem, ITA 85(1)(e.1) allows an assumption that the properties are transferred one at a time. This means that for the transfer of Asset One, if the floor value of $15,000 was elected (this assumes that the non-share consideration provided to the transferor does not exceed this amount), this $15,000 would be subtracted from the UCC of $28,000.

16-69. The resulting UCC balance would be $13,000, and when the depreciable asset rules are applied to Asset Two, this UCC balance of $13,000 would become the floor. If the taxpayer again elected to use the floor value, the $13,000 would be deducted from the UCC and this would reduce the UCC balance to nil without triggering recaptured CCA.

## Exercise Sixteen - 2

**Subject:** Elected Value For Depreciable Property

Eric Li has two depreciable assets - a Class 1 building and a Class 10 vehicle. The assets are to be transferred to a corporation using ITA 85. Relevant information on the assets is as follows:

| | Class 1 | Class 10 |
|---|---|---|
| Fair Market Value Of The Property | $475,000 | $12,000 |
| UCC Of Class (Last Asset In Class) | 150,000 | 8,000 |
| Cost Of The Property | 220,000 | 28,000 |
| Fair Market Value Of The Boot | 250,000 | 10,000 |

What is the possible range of values that can be elected for the two properties? Assume he elects the lowest possible value in each case. What are the tax consequences for Mr. Li?

**SOLUTION available in print and online Study Guide.**

## Depreciable Property - Disallowed Terminal Losses

### *General Rules*

16-70. In Paragraph 16-64, we noted that the terminal loss resulting from the required election on the asset in Example Two will be disallowed. More specifically, if a depreciable property with a fair market value that is less than its UCC is transferred by a person (individual, trust, or corporation) or a partnership to an affiliated person (see Paragraph 16-54), ITA 13(21.2) indicates that:

**Figure 16 - 1**
**Summary Of Section 85 Transfer Price Rules**

| | Inventory And Non-Depreciable Assets | Depreciable Assets |
|---|---|---|
| Ceiling (FMV Of Asset) | X | X |
| Floor - Greater Of: | | |
| A. FMV Of Boot | X | X |
| B. Least Of: | | |
| Tax Cost Of Asset | X | — |
| Cost Of Asset (Not Tax Cost) | — | X |
| FMV Of Asset | X | X |
| UCC Balance | — | X |

- ITA 85 does not apply;
- the proceeds of the disposition are deemed to be the UCC amount, thereby disallowing the terminal loss; and
- the transferee's capital cost for the property is deemed to be the transferor's capital cost, with the excess of that amount over the UCC of the asset deemed to be CCA deducted in previous periods.

16-71. In Example Two from Paragraph 16-64, the property had a capital cost of $30,000, a UCC for the class of $20,000, and a fair market value of $18,000. As the $18,000 fair market value was less than the $20,000 UCC of the class, this means that ITA 85 does not apply to this transfer. In addition, ITA 13(21.2) would disallow this loss on any transfer to an affiliated person by deeming the proceeds of disposition to be equal to the UCC.

16-72. If, however, the property is sold to the corporation for its fair market value, the property will have a deemed capital cost to the transferee of $30,000 and a UCC value of $18,000. The $2,000 disallowed loss will be deemed to be a depreciable property that is owned by the transferor. It will be allocated to the same class as the transferred property for CCA purposes and will be subject to the usual CCA procedures. However, it will be kept in a separate class so that any unamortized amount can be recognized when one of the following events occurs:

- the transferee disposes of the property to a non-affiliated person (includes deemed dispositions);
- the use of the property is changed from income earning to non-income earning;
- if the transferor is a corporation,
    - it is subject to an acquisition of control; or
    - it is subject to an ITA 88(2) winding up.

### *Tax Planning*

16-73. As was noted in our discussion of capital losses on transfers of non-depreciable capital property, Section 85 is normally used in order to defer the taxation of various types of income. If there is a terminal loss present on a depreciable property, ITA 85 cannot be used. This means that, if the asset is necessary to the continued operations of the business, it will be sold to the corporation at fair market value, with any terminal loss on the transaction being disallowed by ITA 13(21.2). If the asset is not necessary to the continued operations of the business, it would be preferable to sell it to a non-affiliated person.

## Summary Of Transfer Price Rules

16-74. Figure 16-1 provides a summary of the transfer price rules that have been discussed in this section.

**We suggest you work Self Study Problems Sixteen-1 and 2 at this point.**

# Allocation Of The Elected Value

## Consideration Received By The Transferor (Shareholder)

16-75. As noted previously, the elected value for the assets transferred is used to establish the adjusted cost base of all consideration received by the transferor. The rules for allocating this total to the various types of consideration that may be used are found in ITA 85(1)(f), (g), and (h). They involve a sequential process that can be outlined as follows:

| | |
|---|---|
| Elected Value (Total Adjusted Cost Base Of All Consideration) | $xxx |
| Less: Adjusted Cost Base Of Non-Share Consideration (Fair Market Value) | ( xxx) |
| Adjusted Cost Base Of All Shares Issued (Usually Nil) | $xxx |
| Less: Adjusted Cost Base Of Preferred Stock Issued (Usually Nil, But Limited To Fair Market Value) | ( xxx) |
| Adjusted Cost Base Of Common Stock Issued (A Residual - Usually Nil) | $xxx |

**EXAMPLE** In transferring his proprietorship assets to a new corporation, Jason Browning elects a value of $972,000 for the assets transferred. As the fair market value of these assets is $1,650,000, he receives the following consideration:

- Cash of $220,000.
- Preferred shares of the new corporation with a fair market value of $345,000.
- Common shares of the new corporation with a fair market value of $1,085,000.

**ANALYSIS** The $972,000 elected value would be allocated as follows:

| | |
|---|---|
| Elected Value (Total Adjusted Cost Base Of All Consideration) | $972,000 |
| Less: Adjusted Cost Base Of Non-Share Consideration (Fair Market Value) | ( 220,000) |
| Adjusted Cost Base Of All Shares Issued (Usually Nil) | $752,000 |
| Less: Adjusted Cost Base Of Preferred Stock Issued (Usually Nil, But Limited To Fair Market Value) | ( 345,000) |
| Adjusted Cost Base Of Common Stock Issued (A Residual - Usually Nil) | $407,000 |

16-76. The preceding example has been designed to illustrate the allocation of the elected value to all three types of consideration. However, in the usual ITA 85 scenario, minimum asset values will normally be elected in order to avoid the recognition of income on the transfer. Boot will then be taken out in an amount equal to these minimum values. This means that in the usual situation, non-share consideration will be equal to the elected value and, in terms of the preceding allocation process, both preferred and common shares will have an adjusted cost base of nil.

### Exercise Sixteen - 3

**Subject:** Transfers Under Section 85 - ACB Of Consideration

Using ITA 85, Mrs. Jennifer Lee transfers non-depreciable capital property to a corporation at an elected value of $62,000. The property has an adjusted cost base of $62,000 and a fair market value of $176,000. As consideration, she receives a note for $51,000, preferred shares with a fair market value of $53,000, and common shares with a fair market value of $72,000. Indicate the adjusted cost base of the individual items of consideration received by Mrs. Lee.

**SOLUTION available in print and online Study Guide.**

## Assets Acquired By The Corporation

### General Rules

16-77. With respect to the assets acquired by the transferee corporation, the basic rules are as follows:

**Non-Depreciable Property** The elected transfer price becomes the tax cost of these assets to the corporation.

**Depreciable Property** Where the transferor's capital cost exceeds the elected value for the property, ITA 85(5) requires that the capital cost to the transferee be equal to the amount that was the capital cost to the transferor. In most cases, the elected value will be equal to the transferor's UCC. ITA 85(5) requires that the difference between these two values be treated as deemed CCA. To illustrate this, consider the following asset:

| | |
|---|---:|
| Cost | $100,000 |
| UCC | 67,000 |
| Fair Market Value | 105,000 |
| Non-Share Consideration | 67,000 |
| Elected Value | 67,000 |

The capital cost of the asset to the transferee will be $100,000, there will be deemed CCA taken of $33,000, and future CCA will be based on the elected value of $67,000. The reason for requiring the transferee to retain the transferor's capital cost is to avoid having the transferor convert potential recaptured CCA into a capital gain, only one-half of which would be taxed.

You should also note that, in the usual situation where the transferor is not dealing at arm's length with the transferee corporation, the half year rules do not apply to the calculation of CCA by the transferee. This is the case as long as the transferor has owned the asset for at least 364 days before the end of the taxation year of the transferee in which the property was acquired, and used it as a capital property to earn business or property income.

16-78. What these rules mean is that, in cases where the election has been made at an amount equal to the transferor's tax cost, the transferee corporation essentially assumes the tax position of the transferor.

### Capital Gains On Transfers Of Depreciable Property

16-79. The objective of using ITA 85(1) is usually to avoid tax consequences when assets are transferred to a corporation. This means that, in general, the elected values will be equal to the transferor's tax values (adjusted cost base or UCC).

16-80. There are, however, circumstances in which the transferor may wish to generate a capital gain through the transfer of assets to a corporation. An example of this might be an individual who has large losses in the current year, or who has unused net capital or non-capital loss carry forwards that he wishes to claim.

16-81. This creates a problem with respect to depreciable assets in that, under the general ITA 85 rules, the elected value becomes the basis for calculating future CCA amounts. An election on a depreciable asset at a value in excess of the capital cost would result in a capital gain, only one-half of which would be taxable. Under the usual disposition rules, this same excess would become part of the UCC, the basis for calculating fully deductible amounts of CCA. The following example will illustrate this problem.

**EXAMPLE** Jan Harding plans to transfer a depreciable asset to a Canadian controlled private corporation in which she is the only shareholder. The relevant values are as follows:

| | |
|---|---|
| Cost | $ 80,000 |
| Fair Market Value | 120,000 |
| UCC | 75,000 |
| Elected Value | 120,000 |

**ANALYSIS** The election at $120,000 would create the following amounts of income:

| | |
|---|---|
| Recaptured CCA ($80,000 - $75,000) | $ 5,000 |
| Taxable Capital Gain [(1/2)($120,000 - $80,000)] | 20,000 |
| Total Income | $25,000 |

In the absence of a special rule, the cost and UCC of this asset to the corporation would be $120,000. This value would create $45,000 more CCA for the corporation than would have been available to the transferor ($120,000 - $75,000). This has been accomplished through an increase in the transferor's Taxable Income of only $25,000, clearly not an equitable situation from the point of view of the government.

16-82. ITA 13(7)(e) acts to correct this situation. You may recall that this provision was discussed in some detail in Chapter 9. It is a general provision that applies to all non-arm's length transfers of depreciable assets, including those where ITA 85(1) has been used.

16-83. When such transfers occur, ITA 13(7)(e) limits the capital cost of the asset for CCA purposes to the transferor's cost, plus one-half of any capital gain that results from the transfer. As applied to the example in Paragraph 16-81, the capital cost to the transferee under ITA 13(7)(e) for CCA, recapture and terminal loss purposes only, would be as follows:

| | | |
|---|---|---|
| Transferor's Cost | | $ 80,000 |
| Elected Transfer Price | $120,000 | |
| Transferor's Cost | ( 80,000) | |
| Capital Gain | $ 40,000 | |
| Taxable Portion | 1/2 | 20,000 |
| Capital Cost To The Transferee For CCA Purposes | | $100,000 |

16-84. Based on this capital cost, the increase in the CCA base to the corporation is only $25,000 ($100,000 - $75,000), the same amount the transferor recognized as income as a result of the transfer. Note, however, that for future capital gains calculations, the capital cost of the asset to the transferee is the elected value of $120,000.

# Paid Up Capital (PUC) Of Shares Issued

## General Rules

16-85. Establishing the Paid Up Capital (PUC) of the shares received is important as it represents an amount that can be distributed to the shareholders as a tax free return of capital. In general, the amount of PUC for tax purposes is equal to the amount attributed to the shares under the appropriate corporate laws (legal stated capital).

16-86. While there are some complications in those provinces that still permit the issuance of par value shares, the legal stated capital of a corporation is generally based on the fair market value of the consideration received in return for issued shares. In the case of shares issued in an ITA 85 rollover, this amount would be equal to the fair market value of the assets transferred.

16-87. In the usual ITA 85 scenario, in order to defer taxation on the asset transfer, assets that have increased in value will be transferred at elected values that are below their respective fair market values. Again, in the usual ITA 85 scenario, the elected values will be equal to the non-share consideration, leaving the adjusted cost base of the shares issued at nil. At this point, the PUC of the shares, which is based on the fair market value of the assets transferred, will exceed the adjusted cost base of the assets by the amount of the deferred gains. If PUC

was left at this value, it would provide the investor with an opportunity to distribute the deferred gains on a tax free basis. To prevent this from happening a PUC reduction is required.

## Paid Up Capital Reduction

16-88. The need for a PUC reduction, as well as the procedure for calculating the reduction can be illustrated using the following example

> **EXAMPLE** A non-depreciable capital asset with a fair market value of $200,000 and an adjusted cost base of $150,000 is transferred under ITA 85 using an elected value of $150,000.
>
> While the usual ITA application would have the transferor receiving non-share consideration of $150,000, in order to better illustrate the mechanics of the PUC reduction, we will assume that the consideration consists of cash of $120,000 and shares with a legal stated capital of $80,000.

16-89. If the asset had been sold to an arm's length party, the vendor would have had an immediate capital gain of $50,000 ($200,000 - $150,000). As is the intent of the legislation, these amounts of income are deferred when Section 85 is used properly. The problem is that, if the $80,000 legal stated capital of the shares issued is used as their PUC, this amount can be withdrawn from the corporation on a tax free basis. This would mean the potential capital gain could permanently escape taxation.

16-90. Given this problem, ITA 85(2.1) requires that the PUC of issued shares be reduced by an amount equal to the total increase in legal stated capital, less any excess of the elected value over non-share consideration given. Continuing with our example, a summary of the facts and the resulting PUC reduction would be as follows:

Asset: Fair market value = $200,000, Adjusted cost base = $150,000

Consideration: Cash = $120,000, Legal stated capital of shares = $80,000

Elected Value (Total amount that can be withdrawn tax free) = $150,000

| | | |
|---|---|---|
| Increase In Legal Stated Capital | | $80,000 |
| Less Excess, If Any, Of: | | |
| Total Elected Value | ($150,000) | |
| Over The Non-Share Consideration | 120,000 | ( 30,000) |
| Reduction In Paid Up Capital (PUC) | | $50,000 |
| | | |
| PUC Of Shares ($80,000 - $50,000) | | $30,000 |

16-91. It is easy to see the conceptual basis for this reduction. The amount of PUC that can be removed by the transferor on a tax free basis is reduced to $30,000, the same amount ($150,000 - $120,000) of consideration he could have received on a tax free basis at the time of the transfer. If the shares were redeemed at their fair market value of $80,000, there would be an ITA 84(3) deemed dividend of $50,000 ($80,000, less a PUC of $30,000). While the taxation of the two amounts is different, this deemed dividend is the same amount as the capital gain that would have resulted from an arm's length sale of the asset. If the non-share consideration had been equal to the elected value of $150,000 (the usual ITA 85 scenario), the PUC would be reduced to nil {$80,000 PUC - [$80,000 - ($150,000 - $150,000)]}.

16-92. A further tax policy problem, which is not resolved by the PUC reduction, relates to the lifetime capital gains deduction. If the asset in the Paragraph 16-88 example is transferred to a corporation at an elected value of $150,000, this would be the adjusted cost base of the shares. If the shares were later sold for their fair market value of $200,000, the result would be a $50,000 capital gain which could be eligible for the lifetime capital gains deduction if they met the requirements. In effect, the use of the ITA 85(1) rollover could result in the complete elimination of tax on the $50,000 capital gain that was present on the asset prior to its transfer.

## More Than One Class Of Shares

16-93. In most Section 85 rollovers, the ITA 85(2.1) formula will reduce the PUC of all shares issued to nil. This reflects the fact that the non-share consideration taken will equal the elected value, resulting in the PUC reduction being equal to the increase in legal stated capital. If this is the case, having more than one class of shares does not create any difficulties.

16-94. If, however, the non-share consideration is less than the elected value, the PUC reduction must be allocated to the various classes of shares. You will recall that, when we allocated the adjusted cost base, it was a sequential process (see Paragraph 16-75). The total adjusted cost base (i.e., the elected value) was allocated first to non-share consideration, then to preferred shares to the extent of their fair market value, and finally to the common shares if a residual remained.

16-95. This is not the case with the PUC reduction. The formula in ITA 85(2.1) is such that the reduction is allocated to different classes of shares on the basis of their relative fair market values.

**EXAMPLE** Joan Creek transfers non-depreciable capital assets with a fair market value of $1,600,000 to a corporation under the provisions of ITA 85(1). The elected value is equal to the $900,000 cost of the assets and, as consideration, she receives cash of $600,000, redeemable preferred shares with a fair market value of $250,000, and common shares with a fair market value of $750,000.

**ANALYSIS** The total adjusted cost base for the consideration would be allocated as follows:

| | |
|---|---|
| Elected Value (Total Adjusted Cost Base Of All Consideration) | $900,000 |
| Non-Share Consideration (Fair Market Value) | ( 600,000) |
| Adjusted Cost Base Of All Shares Issued | $300,000 |
| Less: Adjusted Cost Base Of Preferred Stock Issued (Limited To Fair Market Value) | ( 250,000) |
| Adjusted Cost Base Of Common Stock Issued (Residual) | $ 50,000 |

The PUC reduction would be calculated as follows:

| | | |
|---|---|---|
| Increase In Legal Stated Capital ($250,000 + $750,000) | | $1,000,000 |
| Less Excess, If Any, Of: | | |
| Total Elected Value | ($900,000) | |
| Over The Non-Share Consideration | 600,000 | ( 300,000) |
| Reduction In PUC | | $ 700,000 |

The PUC of the two classes of shares, reduced by a pro rata allocation of the $700,000 PUC reduction on the basis of relative fair market value, would be as follows:

$$\text{PUC Of Preferred Stock}\left[\$250{,}000-\left(\frac{\$250{,}000}{\$1{,}000{,}000}\right)(\$700{,}000)\right]=\underline{\underline{\$75{,}000}}$$

$$\text{PUC Of Common Stock}\left[\$750{,}000-\left(\frac{\$750{,}000}{\$1{,}000{,}000}\right)(\$700{,}000)\right]=\underline{\underline{\$225{,}000}}$$

16-96. Note that the total PUC of the two classes is equal to $300,000 ($75,000 + $225,000). As you would expect, this is equal to the total adjusted cost base of the two classes ($250,000 + $50,000) as well as the difference between the elected value of $900,000 and the non-share consideration of $600,000. The fact that the individual amounts are different reflects the difference between the sequential allocation process for the adjusted cost base amount and the pro rata allocation of the PUC reduction.

## Exercise Sixteen - 4

**Subject:** Transfers Under Section 85 - PUC Reduction

Using ITA 85, Mr. Rob McCleen transfers non-depreciable capital property to a corporation at an elected value of $114,000. The property has an adjusted cost base of $114,000 and a fair market value of $234,000. As consideration he receives a note for $83,000, preferred shares with a fair market value and legal stated capital of $97,000, and common shares with a fair market value and legal stated capital of $54,000. Indicate the adjusted cost base and the PUC of the preferred and common shares that were issued to Mr. McCleen.

**SOLUTION available in print and online Study Guide.**

**We suggest you work Self Study Problem Sixteen-3 at this point.**

# Comprehensive Example - Section 85 Rollovers

## Basic Information

16-97. John Martin has been operating an unincorporated business. On January 1, 2019, the tax costs (UCC or adjusted cost base) and fair market values for its assets and liabilities are as follows:

| | Tax Value | Fair Market Value |
|---|---|---|
| Cash | $ 20,000 | $ 20,000 |
| Accounts Receivable | 50,000 | 49,000 |
| Inventories | 100,000 | 105,000 |
| Prepaid Expenses | 10,000 | 10,000 |
| Land | 50,000 | 70,000 |
| Building (Capital Cost = $150,000) | 110,000 | 140,000 |
| Equipment (Capital Cost = $70,000) | 40,000 | 35,000 |
| Goodwill | Nil | 50,000 |
| Total Assets | $380,000 | $479,000 |
| Liabilities | $100,000 | $100,000 |

## Excluded Assets

16-98. The rollover would involve a new corporation, the Martin Company, assuming all of Mr. Martin's liabilities and acquiring all of his business assets except the following:

| Excluded Asset | Tax Value | Fair Market Value |
|---|---|---|
| Cash | $ 20,000 | $ 20,000 |
| Accounts Receivable | 50,000 | 49,000 |
| Prepaid Expenses | 10,000 | 10,000 |
| Equipment | 40,000 | 35,000 |
| Total Values For Excluded Assets | $120,000 | $114,000 |

16-99. With respect to the Cash and Prepaid Expenses, they are not eligible assets as described under ITA 85(1.1) and cannot be transferred under this rollover provision. However, as their fair market values are equal to their tax values, this is of no consequence.

16-100. The Accounts Receivable could be transferred under ITA 85. However, the $1,000 ($50,000 - $49,000) loss would have to be treated as a capital loss, which would be disallowed as a superficial loss by ITA 40(2)(g). Further, any additional bad debts incurred by the corporation would also have to be treated as capital losses.

16-101. The alternative is a joint election under ITA 22. This allows the $1,000 current loss to be treated as a fully deductible business loss. While the corporation will have to include this $1,000 in income, it will then be able to deduct the full amount of any additional bad debts. Taxpayers are not permitted to simultaneously use both the ITA 22 and the ITA 85 elections for their accounts receivable so we have excluded it from the ITA 85 election.

16-102. With respect to the equipment, its fair market value is less than the UCC for the class. In this case, ITA 13(21.2) indicates that ITA 85 does not apply and the proceeds of disposition are deemed to be the UCC amount of $40,000 thereby disallowing the terminal loss. There will be no tax consequences associated with the transfer and the corporation will retain the Mr. Martin's original capital cost of $70,000 with the difference between the capital cost and the UCC considered deemed CCA. While a terminal loss could have been recognized if the property had been transferred to an arm's length taxpayer, it would have been disallowed in this case because Mr. Martin's corporation is an affiliated person.

## Implementing The Election

16-103. Mr. Martin is interested in deferring all of the capital gains that are present on his assets and, as a consequence, he elects tax values for most of the assets that are to be transferred under ITA 85. The one exception to this is goodwill, which is transferred at a value of $1 to ensure that it is listed in the election. In Mr. Martin's proprietorship's tax records, the proceeds of $1 will be subtracted from Class 14.1, leaving a negative balance in that Class. If there are no additions to this Class prior to the end of 2019, this amount will be treated as recapture and included in Mr. Martin's income. The $1 will also be added to Class 14.1, restoring the balance to nil. In Martin Company's records, the $1 will be added to Class 14.1.

16-104. Mr. Martin's total elected value of $260,001 is calculated as follows:

| | |
|---|---:|
| Tax Values Of Total Assets | $380,000 |
| Tax Value Of Excluded Assets (Paragraph 16-98) | ( 120,000) |
| Nominal Value To Goodwill | 1 |
| Total Elected Value | $260,001 |

16-105. With respect to the consideration to be given to Mr. Martin, it must equal the fair market value of the assets transferred. This amount would be $365,000 ($479,000 total, less the $114,000 fair market value of the excluded assets listed in Paragraph 16-98).

16-106. The normal procedure would be to take back non-share consideration, in this example debt, with a fair market value equal to the elected value of $260,001, along with shares with a fair market value equal to the $104,999 ($365,000 - $260,001) excess of the fair market values of the assets transferred over their elected values. The $260,001 in debt consideration is made up of $100,000 in debt of the existing business that has been assumed by the corporation, plus $160,001 in new debt issued by the corporation.

16-107. The ITA 85(1) election is made on an asset-by-asset basis, requiring both an elected value and specified consideration (which must include some shares) for each asset transferred. In the schedule which follows, non-share consideration is allocated to each asset up to a maximum of its elected value, with share consideration allocated to the asset to reflect the excess of the fair market value of the asset over its elected value. For example, the fair market value of the inventories is $105,000. Reflecting the fact that the elected value for this asset is its tax value of $100,000, $100,000 of non-share consideration is allocated to this asset. The $5,000 in share consideration allocated to this asset is based on the excess of its fair market value over the elected value.

| | | Consideration At Fair Market Value | |
|---|---|---|---|
| | Elected Value | Non-Share | Share |
| Inventories | $100,000 | $100,000 | $ 5,000 |
| Land | 50,000 | 50,000 | 20,000 |
| Building (Capital Cost = $150,000) | 110,000 | 110,000 | 30,000 |
| Goodwill | 1 | 1 | 49,999 |
| Total Assets | $260,001 | $260,001 | $104,999 |

16-108. In this example, the total non-share consideration is equal to the total elected value. If it were less (it cannot be more as the non-share consideration is the general floor for the values to be elected), the amount of non-share consideration allocated to some assets would be less than the full elected value.

16-109. From the point of view of the corporation, the elected values would become the tax values to be used in subsequent periods of operation. The adjusted cost base of the shares that were issued to Mr. Martin would be determined as follows:

| | |
|---|---|
| Total Elected Value | $260,001 |
| Non-Share Consideration | ( 260,001) |
| Adjusted Cost Base Of Shares | Nil |

16-110. The initial PUC of these shares would be their legal stated capital, an amount equal to their fair market value of $104,999. However, there would be an ITA 85(2.1) reduction in this balance as follows:

| | | |
|---|---|---|
| Increase In Legal Stated Capital | | $104,999 |
| Less Excess, If Any, Of: | | |
| Total Elected Value | ($260,001) | |
| Over The Non-Share Consideration | 260,001 | Nil |
| Reduction In PUC | | $104,999 |

16-111. At this point, both the adjusted cost base and the PUC of the shares are nil ($104,999 PUC - $104,999 PUC reduction). If they were redeemed at their $104,999 fair market value, Mr. Martin would have to recognize an ITA 84(3) deemed dividend of $104,999. This deemed dividend would reduce the proceeds of disposition for capital gains purposes to nil, resulting in no capital gain on the redemption.

16-112. Alternatively, if he were to sell the shares at their fair market value, the result would be a capital gain of $104,999. Unlike the redemption scenario which would result in the deferred gain being taxed as a dividend, a sale of shares could completely avoid taxation on the deferred gain. This would happen if the gain resulting from the sale of shares fully qualified for the lifetime capital gains deduction.

## Exercise Sixteen - 5

**Subject:** Transfers Under Section 85 - Tax Consequences

Jasmine Wiens has operated her alternative medicine pharmacy as an unincorporated business for a number of years. The tangible assets of this business have a fair market value of $850,000 and a tax cost of $275,000. In addition to the tangible assets, because the business has been extremely profitable, Jasmine estimates that it has goodwill of $300,000, resulting in a total value for the business of $1,150,000. The total liabilities of the business amount to $83,000. As she no longer needs all of the income that the business is producing, she would like to transfer the business to a new

corporation and, in order to defer taxation, she would like to use the provisions of ITA 85(1) for the transfer.

On January 20, 2019, she will make the transfer at an elected value of $275,000. The corporation will assume the $83,000 in business liabilities and, in addition, issue a note payable to Ms. Wiens in the amount of $17,000. Other consideration will be made up of redeemable preferred shares with a fair market value of $125,000 and common shares with a fair market value of $925,000. Any dividends paid by the corporation will be non-eligible. Determine the following:

1. The adjusted cost base of each type of consideration received by Ms. Wiens.
2. The paid up capital of each type of share issued by the new corporation.
3. The tax consequences to Ms. Wiens of the new preferred shares being redeemed at their fair market value immediately.

**SOLUTION available in print and online Study Guide.**

**We suggest you work Self Study Problems Sixteen-4 to Sixteen-7 at this point.**

# Gift To Related Party - Section 85

## General Rules

16-113. If the transferor of the assets is the only shareholder of the transferee corporation, the indirect gift rules in ITA 85(1)(e.2) are not applicable. However, Section 85 rollovers are often used for income splitting purposes, and this usually means that other members of the transferor's family will be involved as shareholders in the transferee corporation. The indirect gift rules are designed to ensure that, while other family members will be permitted to share in the future growth and income of the corporation, they are not permitted to receive a portion of the current values of the transferred assets in the form of a gift.

16-114. ITA 85(1)(e.2) is applicable if the fair market value of the transferred property exceeds the greater of:

1. the fair market value of all consideration received from the corporation; and
2. the amount elected for the transfer;

and it is reasonable to regard that excess as a gift made by the taxpayer for the benefit of any related shareholder. In any situation where a party related to the transferor is a shareholder of the transferee corporation, it would be reasonable to regard the excess as a gift.

16-115. If ITA 85(1)(e.2) is applicable, the tax consequence is that, except for purposes of determining the adjusted cost base of any shares provided to the transferor, the gift amount will be added to the elected value for the transfer to create a deemed elected value. As this deemed elected value becomes the deemed proceeds of disposition for the transferor and the deemed adjusted cost base of the property to the transferee corporation, this will usually result in a capital gain and/or business income on the rollover.

16-116. A less direct consequence is that the fair market value of the shares held by the related person will be increased by the amount of the gift. As there will be no corresponding increase in the related person's adjusted cost base, the sale of these shares will result in a taxable capital gain.

## Example

16-117. The following example will serve to illustrate the application of ITA 85(1)(e.2).

**EXAMPLE** Mr. Pohl owns a non-depreciable capital property with an adjusted cost base of $30,000. He estimated its fair market value was $130,000. A new

corporation is formed with all of the common shares being issued to Mr. Pohl's adult son for $1,000 in cash. Using the provisions of ITA 85(1), Mr. Pohl then transfers his non-depreciable property to the corporation at an elected value of $30,000.

The corporation issues a $30,000 note payable and preferred shares with a fair market value and a legal stated capital of $100,000 to Mr. Pohl. By taking back $130,000 ($30,000 + $100,000) in total consideration, Mr. Pohl is filing the election on the basis that the fair market value of the non-depreciable property is also $130,000 and there is no capital gain on this transaction. However, on review, the CRA reassesses him on the basis that the actual fair market value of the property is $180,000. Mr. Pohl, after a heated exchange with his accountant, agrees to accept this value.

16-118. Based on the reassessed value, the fair market value of the property transferred exceeds the fair market value of the consideration received as shown in the following calculation:

| | |
|---|---|
| Fair Market Value Of Property Transferred (Reassessed Value) | $180,000 |
| Less The Greater Of: | |
| • FMV Of Consideration Received = $130,000 | |
| • Elected Amount = $30,000 | ( 130,000) |
| Excess (Gift) | $ 50,000 |

16-119. As Mr. Pohl's son is the only common shareholder of the new corporation, it would be reasonable to regard this $50,000 as a gift to his son. This would make ITA 85(1)(e.2) applicable to this transaction and Mr. Pohl would have a taxable capital gain determined as follows:

| | |
|---|---|
| Deemed Elected Value = Deemed Proceeds Of Disposition | |
| ($30,000 + $50,000 Gift) | $80,000 |
| Adjusted Cost Base | ( 30,000) |
| Capital Gain | $50,000 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain | $25,000 |

16-120. Any CRA reassessment of the fair market values will involve specific assets. In this example, only one non-depreciable asset is involved and this means that the result will be a capital gain on that asset. If depreciable assets or inventories were involved, there could also be recapture or business income.

16-121. We noted in Paragraph 16-115 that the ITA 85(1)(e.2) deemed elected value does not apply in determining the adjusted cost base of the shares received by the transferor. Given this, the adjusted cost base of Mr. Pohl's preferred shares would be calculated as follows:

| | |
|---|---|
| Elected Value (Original) | $30,000 |
| Non-Share Consideration | ( 30,000) |
| Adjusted Cost Base Of Preferred Shares | Nil |

16-122. Note, however, the deemed elected value does apply to the cost figure that is used in the following PUC reduction calculation under ITA 85(2.1). This would be relevant if there was a share redemption.

| | | |
|---|---|---|
| Increase In Legal Stated Capital | | $100,000 |
| Less The Excess, If Any, Of: | | |
| Deemed Elected Value | ($80,000) | |
| Over The Non-Share Consideration | 30,000 | ( 50,000) |
| PUC Reduction | | $ 50,000 |
| PUC Of Shares ($100,000 - $50,000) | | $ 50,000 |

16-123. The other relevant fact here is that the transferee corporation, in addition to the $1,000 invested by Mr. Pohl's son, has an asset with a fair market value of $180,000. Given this, the fair market value of the son's shares would be $51,000 ($181,000 - $30,000 - $100,000). As there has been no change in the adjusted cost base of the son's shares, a subsequent sale of the shares would result in a capital gain of $50,000 ($51,000 - $1,000).

16-124. The actual and potential gains resulting from the application of ITA 85(1)(e.2) to this transaction are as follows:

| | |
|---|---|
| Actual Capital Gain On Transfer | $ 50,000 |
| Potential Gain On Mr. Pohl's Preferred Shares ($100,000 - Nil) | 100,000 |
| Potential Gain On Son's Common Shares ($51,000 - $1,000) | 50,000 |
| Total Gain | $200,000 |

16-125. If Mr. Pohl had simply sold his property, the total gain would have been only $150,000 ($180,000 - $30,000), $50,000 less than the total gain in the preceding table. In effect, the $50,000 amount of the gift will be subject to double taxation.

16-126. This example illustrates the importance of taking great care in establishing the fair market value of the property being transferred. A failure to do so can result in the double taxation that is illustrated here.

16-127. Once that fair market value has been established, the transferor should take back a non-growth security such as preferred shares for the difference between the fair market value of the property and its tax value. Common shares can then be issued to the other family members at a nominal value. While the initial value of these shares will be nominal, it will be these shares that will have growth in value in the future.

## Exercise Sixteen - 6

**Subject:** Gift To Related Party - Section 85

Janice Bellows establishes a new CCPC, arranging to have all of its common shares issued to her adult daughter for cash of $1,000. Ms. Bellows then transfers, using ITA 85, non-depreciable capital property with an adjusted cost base of $50,000 and an estimated fair market value of $65,000. The transfer is made at an elected value of $50,000. As consideration for this property, the corporation gives Ms. Bellows a note for $50,000 and preferred stock with a fair market value and a legal stated capital of $15,000.

A CRA reassessment of this transaction determines that the actual fair market value of the property transferred is $110,000. Ms. Bellows reluctantly accepts this value. After the reassessment, Ms. Bellows and her daughter sell their shares for their fair market value.

Taking into consideration the reassessment, describe the tax consequences of these transactions for both Ms. Bellows and her daughter. How would these tax consequences differ if Ms. Bellows had simply sold the non-depreciable capital property for its post-reassessment value of $110,000?

**SOLUTION available in print and online Study Guide.**

**We suggest you work Self Study Problem Sixteen-8 at this point.**

# Excess Consideration - Section 85

## Introduction

16-128. In the previous section we considered the tax consequences of the transferor receiving consideration that is less than the fair market value of the property transferred. In this section we are concerned with the opposite case. Here we are concerned with situations in which the value of the consideration received exceeds the value of the assets transferred. When this is the case, the result will be a taxable benefit assessed to the transferor under ITA 15(1). Note that ITA 15(1), which is discussed in detail in Chapter 15, is a provision that covers a broad variety of transactions that can create taxable benefits to the recipient shareholder.

16-129. In situations where ITA 85 is used to roll assets into an existing corporation that has assets other than those transferred in, share consideration or a combination of share consideration can result in an excess consideration situation. However, if the transfer is to a new corporation with no other shareholders, an ITA 15(1) benefit can only arise if the non-share consideration exceeds the value of the assets transferred. This reflects the fact that any shares issued, when combined with the value of the non-share consideration, cannot have a value in excess of the fair market value of the assets transferred to the new corporation.

> **EXAMPLE** An asset with a fair market value of $100,000 is transferred to a new corporation using ITA 85(1). The transferor receives $100,000 in non-share consideration as well as preferred shares. (To use Section 85, at least one share must be issued by the transferee.)
>
> **ANALYSIS** As the $100,000 in non-share consideration is equal to the fair market value of the assets transferred, the shares can only have a nominal value. Given this, they cannot create an excess consideration situation. Note that on transfers to a new corporation, if the non-share consideration is equal to, or greater than, the fair market value of the assets transferred, the shares that will be issued will have both an adjusted cost base and a PUC of nil.
>
> In order to simplify our coverage of this fairly minor topic of excess consideration, we will limit our examples and problems to situations involving transfers to new corporations where the fair market value of the non-share consideration exceeds the fair market value of the assets transferred.

16-130. Excess consideration situations do not usually involve a deliberate attempt by the taxpayer to receive an inappropriate amount of consideration. Rather the typical scenario involves the taxpayer filing an ITA 85 election using an estimated fair value for the assets transferred, with the CRA later reassessing based on a lower value for the assets. This is illustrated in the example in the next section.

## Shareholder Benefit - ITA 15(1)

16-131. The following example illustrates a situation in which the use of ITA 85(1) results in a taxable benefit to the transferor.

> **EXAMPLE** In 2018, Ms. Sally Swit transfers non-depreciable capital property to a new corporation in which she owns 100 percent of the shares using ITA 85(1). The property has an adjusted cost base of $65,000 and she believes it has a fair market value of $200,000. She takes back debt with a fair market value of $200,000 and preferred shares with a nominal value. In her 2018 tax return, she shows a taxable capital gain of $67,500 [(1/2)($200,000 - $65,000)].
>
> In 2019, the CRA reassesses on the basis that the fair market value of the property was only $150,000 at the time of the transfer. Ms. Swit accepts this reassessed value and does not file an objection.
>
> **ANALYSIS** Based on the original estimated fair market value for the property transferred, there was no excess consideration. However, with the reassessment value of $150,000 there is an excess, resulting in the following ITA 15(1) benefit:

| | |
|---|---|
| Fair Market Value Of Consideration | $200,000 |
| Reassessed Fair Market Value Of The Property | ( 150,000) |
| ITA 15(1) Shareholder Benefit | $ 50,000 |

With the value of the property transferred reassessed to $150,000, the elected value cannot exceed this amount. Based on this, there would be a revised taxable capital gain on the transfer, calculated as follows:

| | |
|---|---|
| Elected Value Of Property After Reassessment | $150,000 |
| Adjusted Cost Base | ( 65,000) |
| Capital Gain | $ 85,000 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain On Property After Reassessment | $ 42,500 |

The reassessment increases 2018 Net Income For Tax Purposes from $67,500 to $92,500 ($50,000 + $42,500), an increase of $25,000 as shown in the following:

| | |
|---|---|
| Taxable Capital Gain After Reassessment | $ 42,500 |
| Shareholder Benefit After Reassessment | 50,000 |
| Reversal Of Reported Taxable Capital Gain | ( 67,500) |
| Total Addition To Net Income For Tax Purposes | $ 25,000 |

The reason for this increase is that $50,000 of the capital gain, only one-half of which would be taxed, was converted to a 100 percent taxable shareholder benefit of $50,000. Because a $50,000 benefit will be included in Ms. Swit's income as a result of a property acquisition, ITA 52(1) requires that this amount be added to the adjusted cost base of the non-share consideration. Given this, the adjusted cost base of the non-share consideration would be as follows:

| | |
|---|---|
| Elected Value | $150,000 |
| ITA 15(1) Shareholder Benefit | 50,000 |
| Adjusted Cost Base Of Non-Share Consideration | $200,000 |

As explained in Paragraph 16-129, both the adjusted cost base and the PUC of the preferred shares issued is nil.

## Exercise Sixteen - 7

**Subject:** Benefit To Transferor (Excess Consideration) - Section 85

In 2018, Mr. Larry Custer uses ITA 85 to transfer non-depreciable capital property to a new CCPC in which he owns 100 percent of the shares. The adjusted cost base of the property is $123,000 and he believes that its fair market value is $270,000. In consideration for this property, Mr. Custer receives a note for $270,000 and preferred shares with a nominal value.

In 2019, Mr. Custer is reassessed on the basis that the fair market value of the transferred property was only $217,000. He accepts the reassessment without objection.

Describe the tax consequences of the transfer and the reassessment. Indicate the adjusted cost base of the consideration, and the adjusted cost base and the PUC of the preferred shares after the reassessment.

**SOLUTION available in print and online Study Guide.**

**We suggest you work Self Study Problem Sixteen-9 at this point.**

# Dividend Stripping — ITA 84.1

## Background

### The General Concept

16-132. The term dividend stripping is applied to two types of situations, depending on when the relevant shares were issued by the corporation. In simple terms, both scenarios involve an individual who is attempting to remove assets from a corporation on a tax free basis.

16-133. Attaining this goal can be accomplished if the individual was willing to give up control by selling his shares to an arm's length party. However, when this is not the case and the individual retains control, the dividend stripping rules will often prevent the tax free removal of assets.

16-134. One approach to removing assets from a corporation while still retaining control would be to pay dividends. However, dividends will be taxed in the hands of the recipient and, being a rational individual, the owner of the corporation would prefer to receive the assets on a tax free basis.

16-135. Currently, the usual approach to accomplishing the goal of removing funds from a controlled corporation on a tax free basis is to convert what is, in effect, a dividend payment into a capital gain that would be eligible for the lifetime capital gains deduction. This is the origin of the term "dividend stripping". ITA 84.1 is a provision that is intended to thwart such efforts.

### Pre-1972 Shares

16-136. At an earlier point in time, the most important application of ITA 84.1 was to prevent the conversion of pre-1972 earnings into a pre-1972 capital gain. As we noted in Chapter 8, prior to 1972, capital gains were not subject to tax in Canada. Given this, such a conversion could have resulted in the tax free receipt of a considerable amount of assets. While such situations still arise, they are not of sufficient importance to cover in a general text such as this. As a consequence, the application of ITA 84.1 in this type of situation will not receive further attention.

### Qualified Small Business Corporation Shares

16-137. The most important current application of the dividend stripping rules from ITA 84.1 involves shares of a qualified small business corporation. The capital gains on dispositions of such shares are eligible for the lifetime capital gains deduction. This means that, if an individual can remove the retained earnings of such a corporation in the form of a capital gain, a very large amount of income can be received on a tax free basis. In general, ITA 84.1 serves to make such conversions difficult. The text and problems in this section will focus on this application of the dividend stripping rules that are found in ITA 84.1.

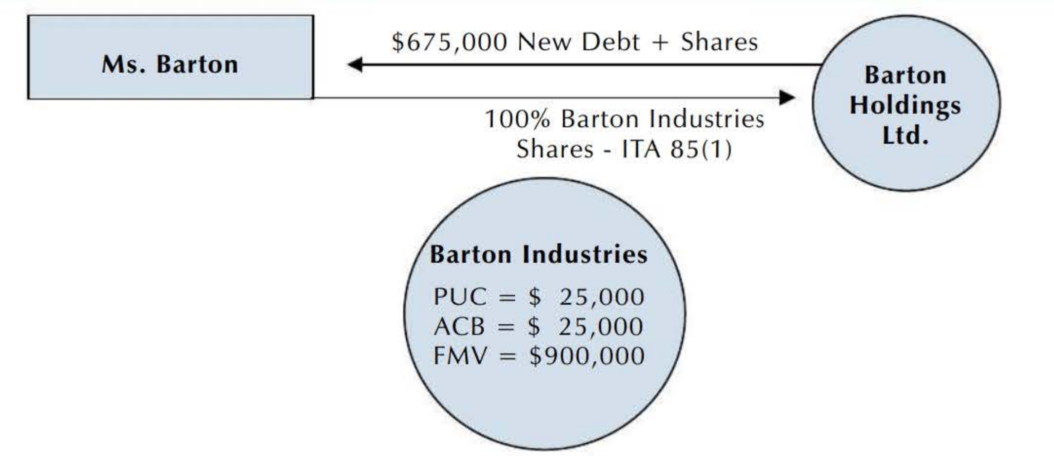
## Applicability Of ITA 84.1

16-138. ITA 84.1(1) specifies the conditions under which the dividend stripping rules become applicable. These conditions are as follows:

- there is a disposition by a resident Canadian taxpayer (other than a corporation) of shares of a resident Canadian corporation (the subject corporation);
- the taxpayer held the shares as capital property (i.e., the shares were held to produce income, not for resale at a profit);
- the disposition is made to a corporation with which the taxpayer does not deal at arm's length; and
- the subject corporation must be connected with the purchaser corporation after the disposition of shares (i.e., the purchaser corporation must control the subject corporation or own more than 10 percent of the voting shares and 10 percent of the fair market value of all shares).

16-139. When these conditions are present, the provisions of ITA 84.1 will generally serve to eliminate the individual's ability to achieve their dividend stripping goals.

**Figure 16 - 2**
**Application Of ITA 84.1 To Post-1971 Shares**




## Dividend Stripping Example

### *Basic Example*

16-140. A simple example will serve to illustrate the application of ITA 84.1 to post-1971 shares. As shown in Figure 16-2, Ms. Barton is the only shareholder of Barton Industries (BI), a Canadian controlled private corporation. The Company was established in 1986 with an investment of $25,000 on the part of Ms. Barton. There has been no additional investment in the Company and, as a consequence, $25,000 is the adjusted cost base of her shares as well as their PUC. The shares have a fair market value of $900,000. Because of her previous use of the lifetime capital gains deduction, Ms. Baron's available balance for the year is limited to $650,000. The shares of BI are qualified small business corporation shares. The Company has no opening balance in its GRIP account.

16-141. Ms. Barton could, of course, make use of her lifetime capital gains deduction by selling the BI shares to an arm's length party and realizing a capital gain of $875,000 ($900,000 - $25,000). However, this approach would result in tax payable as the capital gain of $875,000 exceeds the $650,000 deduction that she has available. In addition, and perhaps more importantly, she would lose control of BI.

16-142. Given these considerations, she chooses to transfer the BI shares to a new company, Barton Holdings Ltd. (BHL), using the provisions of ITA 85(1). Ms. Barton uses an elected value for the transfer of $675,000, in order to limit her capital gain to $650,000 ($675,000 - $25,000). She takes back $675,000 in new debt of BHL, along with the common shares of the new Company. These shares have a fair market value of $225,000 ($900,000 - $675,000) and an adjusted cost base of nil.

16-143. Through this procedure, Ms. Barton appears to have realized the required $650,000 of the accrued capital gain on the BI shares and, at the same time, retained control of the Company. However, Ms. Barton:

- is an individual, resident in Canada;
- held the shares as capital property;
- has made a disposition of shares to a corporation with which she does not deal at arm's length; and
- has created connected corporations subsequent to the transaction since BHL owns all of the shares of BI.

16-144. Given these facts, the dividend stripping provisions of ITA 84.1 would be applicable to this transaction.

## *ITA 84.1 Procedures*

16-145. The ITA 84.1 procedures begin with a reduction in the PUC of any shares of the subject corporation that are received by Ms. Barton. Note that, when both ITA 85 and ITA 84.1 are involved, the PUC reduction rules specified in ITA 84.1(1)(a) must be used. They would apply as follows in this situation.

| | | |
|---|---|---|
| Increase In Legal Stated Capital Of BHL Shares | | $225,000 |
| Less Excess, If Any, Of: | | |
| PUC Of Barton Industries Shares (Note One) | ($ 25,000) | |
| Over The Non-Share Consideration | 675,000 | Nil |
| ITA 84.1(1)(a) PUC Reduction (Note Two) | | $225,000 |

**Note One** This amount is technically the greater of the PUC of the subject shares and their adjusted cost base. In this example, the two amounts are equal.

**Note Two** In those cases where the boot is equal to or exceeds the greater of the PUC and the adjusted cost base of the subject corporation shares, the PUC reduction will be 100 percent of the PUC of the new shares.

16-146. This would leave the PUC of the new shares at nil ($225,000 - $225,000). Given this, the ITA 84.1(1)(b) deemed dividend would be calculated as follows:

| | | |
|---|---|---|
| Increase In Legal Stated Capital Of BHL Shares | | $225,000 |
| Non-Share Consideration | | 675,000 |
| Total | | $900,000 |
| Less The Sum Of: | | |
| The Greater Of The PUC And ACB Of Barton Industries (Subject) Shares | ($ 25,000) | |
| PUC Reduction Under ITA 84.1(1)(a) | ( 225,000) | ( 250,000) |
| ITA 84.1(1)(b) Deemed Dividend (Non-Eligible) | | $650,000 |

16-147. The results from Ms. Barton's disposition of her BI shares would be as follows:

| | |
|---|---|
| Elected Proceeds Of Disposition | $675,000 |
| ITA 84.1(1)(b) Deemed Dividend (See Note) | ( 650,000) |
| ITA 54 Deemed Proceeds Of Disposition | $ 25,000 |
| Adjusted Cost Base Of Barton Industries Shares | ( 25,000) |
| Capital Gain | Nil |

**Note** The definition of proceeds of disposition in ITA 54 indicates that it does not include any amount that is deemed by ITA 84.1(1) to be a dividend. In the absence of this exclusion, the deemed dividend could be taxed a second time as part of a taxable capital gain.

16-148. As the preceding example makes clear, the effect of ITA 84.1 in this situation is to convert the $650,000 capital gain on the BI shares into an ITA 84.1 deemed dividend. This means that Ms. Barton will not be able to make use of her lifetime capital gains deduction and that she will be subject to taxation on the deemed dividend. ITA 84.1 has clearly served to make this type of transaction unattractive.

16-149. As a final point, you should note that Ms. Barton could have achieved her goal of triggering a capital gain for purposes of the lifetime capital gains deduction. Her problem was that she also wanted to remove the gain in the form of non-share consideration. If, as an alternative, she had elected the same transfer price of $675,000, but limited the non-share consideration to the $25,000 PUC amount, she would have had her $650,000 capital gain without creating an ITA 84.1 deemed dividend. Note, however, that she does not have the $650,000 in cash. She would be holding shares with a value of $650,000 and an adjusted cost

base of nil. In order to have the cash and take advantage of the lifetime capital gains deduction, she would have to sell the shares to an arms' length party and lose control of the corporation.

## Exercise Sixteen - 8

**Subject:** Dividend Stripping

Miss Sarah Cole owns 100 percent of the outstanding shares of Cole Inc., a qualified small business corporation. The shares have a PUC and an adjusted cost base of $125,000 and a fair market value of $767,000. The Company has no balance in its GRIP account. On February 1, 2019, Miss Cole uses ITA 85(1) to transfer these shares to Sarah's Holdings Ltd., at an elected value of $767,000. As consideration, she receives a note for $450,000 and preferred shares with a fair market value and a legal stated capital of $317,000. Miss Cole owns all of the shares of Sarah's Holdings Ltd. and has never made use of her lifetime capital gains deduction. What are the tax consequences of this transaction to Miss Cole?

**SOLUTION available in print and online Study Guide.**

**We suggest you work Self Study Problem Sixteen-10 at this point.**

# Capital Gains Stripping — ITA 55(2)

## The Problem

16-150. A problem similar to that involved in dividend stripping arises when a corporation owns shares in a different corporation. If there is an accrued capital gain on these shares, a disposition of the shares will result in the recognition of that gain. Further, corporations are not eligible to use the lifetime capital gains deduction. This means that a disposition of the shares of the investee corporation for a gain will result in an increase in Taxable Income for the selling corporation.

16-151. While capital gains are subject to corporate income taxes, dividends received from taxable Canadian corporations can escape corporate taxes. This means that, if the investor corporation can devise some method of disposing of its investment so that the accrued gain can be received in the form of dividends rather than as a taxable capital gain, the payment of corporate taxes can be avoided.

16-152. In the absence of an anti-avoidance provision, this could be accomplished in a variety of ways. To illustrate this, assume the following:

- The Investee Company is a wholly owned subsidiary of the Investor Company.
- There is an accrued capital gain on the Investee Company shares.
- There is an arm's length purchaser who is prepared to buy the Investee Company shares at their fair market value.

16-153. There are several approaches that could be used in an attempt to convert the accrued capital gain into dividends that could be received by the Investor Company on a tax free basis. The two approaches that we will consider here can be described as follows:

- **Approach One** ITA 85(1) could be used to roll the Investee Company shares to a purchaser corporation at an elected value equal to the adjusted cost base of the Investee Company shares, resulting in no increase in Taxable Income for the Investor Company. As consideration, the purchaser corporation would issue preferred shares that are redeemable at the fair market value of the Investee Company shares. When the preferred shares are redeemed, the result will be an ITA 84(3) deemed dividend which can be received by the Investor Company on a tax free basis. Once again, it

would appear that the Investor Company has disposed of the Investee Company shares without any increase in Taxable Income or Tax Payable.

- **Approach Two** The Investee Company could assume debt equal to the accrued gain on its shares. This Company would then, using the borrowed funds, pay a dividend equal to the accrued gain. This would reduce the fair market value of the Investee Company shares by the amount of the accrued gain, leaving the Investee Company shares with a fair market value equal to their adjusted cost base. They could then be sold with no tax consequences. As the dividend would be received by the Investee Company on a tax free basis, it would appear that the Investor Company has disposed of the Investee Company shares without any increase in Taxable Income or Tax Payable.

16-154. Such procedures are referred to as capital gains stripping, reflecting the fact that it is an attempt to "strip" out a capital gain in the form of a non-taxable, intercorporate dividend. ITA 55(2) is an anti-avoidance provision designed to prevent such conversions of capital gains to dividends by a corporation disposing of an investment in shares.

## Application Of ITA 55(2)

### *Conditions For ITA 55(2) To Apply*

16-155. In somewhat simplified terms, the provisions of ITA 55(2) act to prevent capital gains stripping when the following conditions are present:

- An Investor Company receives dividends that are deductible in the determination of its Taxable Income as part of a transaction, or series of transactions, involving a disposition of Investee Company shares owned by the Investor Company.
- It is determined that one of the purposes of the dividend was to significantly reduce the capital gain on Investee Company shares which would have been included in the Net Income For Tax Purposes of the Investor Company, in the absence of the dividend.
- The disposition of the Investee Company shares was to an arm's length party. While we will not illustrate this in our coverage of this subject, ITA 55(2) would also be applicable if there was a significant increase in an arm's length party's interest in either the Investor Company or the Investee Company.

### *Application Of ITA 55(2)*

16-156. If the conditions specified in Paragraph 16-155 are present, the following rules apply to the dividend:

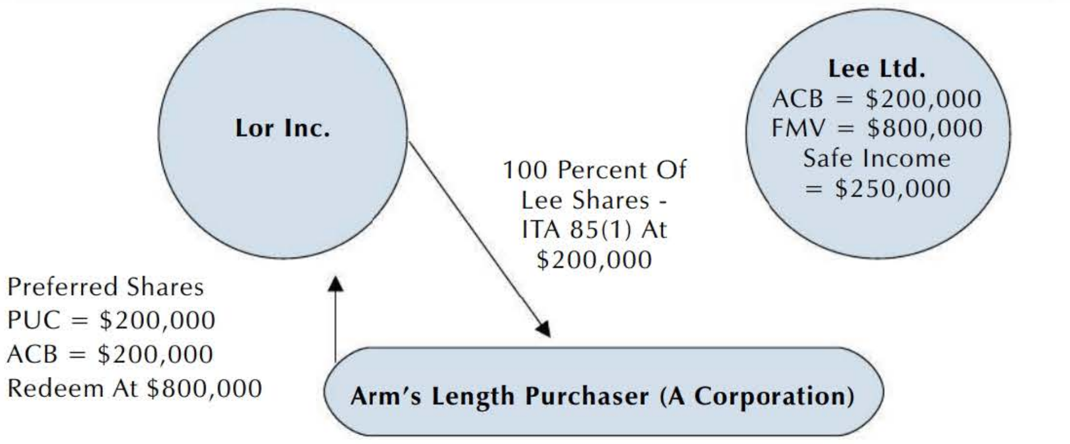
**ITA 55(2)(a)** This provision indicates that the dividend received by the Investor Company will be deemed not to be a dividend except to the extent that the Company has a Safe Income balance (see following description). To the extent that a Safe Income balance is available, the dividend will retain its status as a dividend.

In simplified terms, Safe Income is income that has accrued after 1971 or, if the acquisition of the shares was after that date, after the date on which the shares were acquired. We would note that recent amendments to ITA 55 have made the computation of safe income considerably more complex. Coverage of these complications goes beyond the scope of this introductory text.

Note that this provision only serves to remove the dividend status from the payment received by the Investor Company. It does not indicate the tax status of the payment subsequent to its removal from the dividend category. This is accomplished using ITA 55(2)(b) or ITA 55(2)(c).

**ITA 55(2)(b)** If shares are cancelled, an ITA 84(2) dividend can arise. Similarly, if shares are redeemed, an ITA 84(3) dividend can arise. If the conditions for the application of ITA 55(2) are present, ITA 55(2)(a) deems all or part of the dividend to not be

**Figure 16 - 3**
**Application Of ITA 55(2) - Example One (Approach One)**




a dividend and ITA 55(2)(b) deems the disallowed portion of the payment to be proceeds of disposition, except to the extent that it is otherwise included in computing such proceeds.

**ITA 55(2)(c)** If the conditions for the application of ITA 55 are present and ITA 55(2)(b) does not apply, the portion of the payment that is deemed not to be a dividend by ITA 55(2)(a) is deemed to be a capital gain of the Investor Company.

## Capital Gains Stripping - Example One

16-157. This first example depicts Approach One that is described in Paragraph 16-153. It is diagramed in Figure 16-3.

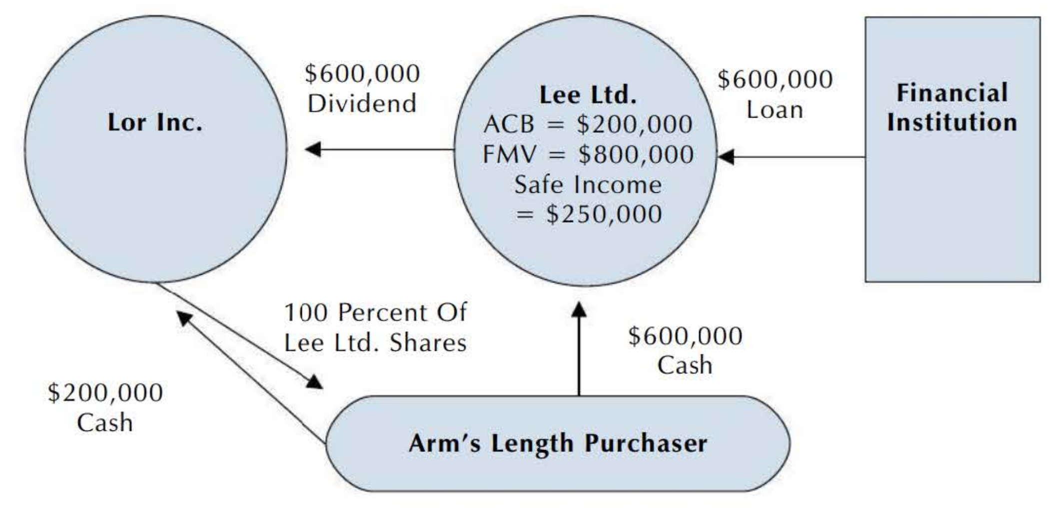
16-158. In this example, ITA 85(1) is used to roll the Lee Ltd. shares into the purchaser corporation at an elected value equal to the $200,000 adjusted cost base of the shares. As consideration for the shares, Lor Inc. takes back $800,000 in redeemable preferred shares. These shares have a PUC and an adjusted cost base of $200,000.

16-159. As you may recall from Chapter 14, a redemption is also a disposition. This requires the calculation of both a proceeds of redemption and a proceeds of disposition. Such transactions can result in an ITA 84(3) dividend, a capital gain, or both. The relevant calculations in this example are as follows:

| | |
|---|---|
| Proceeds Of Redemption | $800,000 |
| PUC Of Shares | ( 200,000) |
| ITA 84(3) Deemed Dividend [Absence Of ITA 55(2)] | $600,000 |
| Proceeds Of Disposition | $800,000 |
| Less The ITA 84(3) Dividend | ( 600,000) |
| Adjusted Proceeds Of Disposition | $200,000 |
| Adjusted Cost Base | ( 200,000) |
| Capital Gain [Absence Of ITA 55(2)] | Nil |

16-160. In the absence of ITA 55(2), the ITA 84(3) dividend would be deducted in determining Lor's Taxable Income and Lor would have succeeded in disposing of the Lee shares for $800,000, without incurring any taxation. The provisions of ITA 55(2) will act to prevent this result from being realized.

**Figure 16 - 4**
**Application Of ITA 55(2) - Example Two (Approach Two)**




16-161. ITA 55(2)(a) will deem any dividend that is not from Safe Income to not be a dividend. In this example, that amount would be $350,000 ($600,000 - $250,000). While $250,000 would retain its status as an ITA 84(3) dividend, under ITA 55(2)(b), the $350,000 would be deemed to be proceeds of disposition. As a result, the tax consequence to Lor would be calculated as follows:

| | |
|---|---|
| Adjusted Proceeds Of Disposition (See Calculation In Paragraph 16-159) | $200,000 |
| Deemed Proceeds Of Disposition - ITA 55(2)(b) | 350,000 |
| Total Proceeds Of Disposition | $550,000 |
| Adjusted Cost Base | ( 200,000) |
| Capital Gain | $350,000 |

16-162. As can be seen in the preceding calculation, ITA 55(2) has served to convert $350,000 of the ITA 84(3) dividend into a capital gain of $350,000. The $250,000 dividend from Safe Income can be deducted under ITA 112 in the determination of Lor's Taxable Income, resulting in no tax cost.

## Capital Gains Stripping - Example Two

16-163. This second example depicts Approach Two that is described in Paragraph 16-153. It involves the same two Companies that were used in Example One. The only difference is in the approach that they use in attempting to convert the capital gain into a tax free dividend. It is diagramed in Figure 16-4.

16-164. In this example, Lor Inc. owns 100 percent of the shares of Lee Ltd. The shares have a fair market value of $800,000, an adjusted cost base of $200,000, and a potential capital gain of $600,000. Lee Ltd. has safe income of $250,000. An arm's length purchaser is willing to pay $800,000 for these shares. In order to implement this sale, Lor Inc. arranges the following:

- Lee Ltd. borrows $600,000 from a financial institution.
- The borrowed funds are used to pay a $600,000 tax free dividend to Lor Inc. This reduces the fair market value of Lee Ltd. to $200,000 ($800,000 - $600,000).

- Lor Inc. sells the shares to the arm's length purchaser for $200,000 in cash. As this is the adjusted cost base of the shares, there will be no capital gain.
- The arm's length purchaser invests $600,000 in Lee Ltd., with the funds being used to retire the $600,000 loan.

16-165. In the absence of ITA 55(2), Lor Inc. would have managed to dispose of its interest in Lee Ltd. in a series of transactions for $800,000 ($200,000 received directly from the purchaser and $600,000 of tax-free dividends financed indirectly by the purchaser), without the recognition of a capital gain. However, ITA 55(2) will prevent this from happening.

16-166. Under ITA 55(2)(a), the portion of the $600,000 dividend that is not from Safe Income will be deemed not to be a dividend to Lor Inc., the dividend recipient. Under ITA 55(2)(c), this portion of the dividend will treated as a capital gain on the disposition of capital property. This result is shown in the following calculation:

| | |
|---|---|
| Dividends Received | $600,000 |
| Dividend Attributable To Safe Income - Retains Status As A Dividend | ( 250,000) |
| Amount Deemed By ITA 55(2)(a) To Not Be A Dividend And By ITA 55(2)(c) To Be A Capital Gain | $350,000 |

16-167. As was the result in Example One, ITA 55(2) has served to convert the portion of the dividend not paid from Safe Income into a capital gain, which will be taxed. The $250,000 portion of the dividend attributable to Safe Income will retain its status as a dividend and can be deducted in the determination of Lor's Taxable Income.

## Exercise Sixteen - 9

**Subject:** Capital Gains Stripping

Markem Ltd. owns 100 percent of the outstanding common shares of Larkin Ltd. The shares of Larkin have an adjusted cost base of $75,000 and a fair market value of $840,000. Included in its Retained Earnings balance is $225,000 of income that has been earned since its acquisition by Markem Ltd. Markem Ltd. would like to sell its shares in Larkin Ltd. In order to implement this sale, Markem Ltd. has instructed Larkin Ltd. to borrow $750,000 from its bank, and use all of these funds to pay a dividend on the shares held by Markem Ltd. The shares are then sold to Mr. J. Leaner for $90,000. Mr. Leaner is not related to Markem Ltd. or Larkin Ltd. What are the tax consequences to Markem Ltd. of these transactions?

**SOLUTION available in print and online Study Guide.**

**We suggest you work Self Study Problem Sixteen-11 at this point.**

**Additional Supplementary Self Study Problems Are Available Online.**

# Key Terms Used In This Chapter

16-168. The following is a list of the key terms used in this Chapter. These terms, and their meanings, are compiled in the Glossary located at the back of the Study Guide.

| | |
|---|---|
| Adjusted Cost Base | Non-Share Consideration |
| Affiliated Group Of Persons | Paid Up Capital |
| Affiliated Person - ITA 251.1(1) | PUC |
| Boot | Recapture Of CCA |
| Capital Cost | Rollover |
| Capital Gains Stripping | Safe Income |
| Controlled - ITA 251.1(3) | Subject Corporation |
| Corporation | Superficial Loss - ITA 54 |
| Depreciable Capital Property | Taxpayer |
| Dividend Stripping | Terminal Loss |
| Eligible Capital Property | Transfer |
| Gift | Transferee |
| Individual | Transferor |
| Non-Depreciable Capital Property | Undepreciated Capital Cost (UCC) |

# References

16-169. For more detailed study of the material in this Chapter, we would refer you to the following:

| | |
|---|---|
| ITA 13(21.2) | Loss On Certain Transfers |
| ITA 15(1) | Benefits Conferred On A Shareholder |
| ITA 40(2)(g) | Superficial Losses |
| ITA 40(3.4) | Loss On Certain Properties |
| ITA 54 | Definitions (Proceeds Of Disposition And Superficial Loss) |
| ITA 55(2) | Deemed Proceeds Or Capital Gain |
| ITA 84.1(1) | Non-Arm's Length Sale Of Shares |
| ITA 85 | Transfer Of Property To Corporation By Shareholders |
| ITA 89(1) | Definitions |
| ITA 251.1 | Affiliated Persons |
| IC 76-19R3 | Transfer Of Property To A Corporation Under Section 85 |
| S4-F3-C1 | Price Adjustment Clauses |
| IT-188R | Sale of Accounts Receivable |
| IT-291R3 | Transfer Of Property To A Corporation Under Subsection 85(1) |
| IT-489R | Non-Arm's Length Sale Of Shares To A Corporation |

# Problems For Self Study (Online)

To provide practice in problem solving, there are Self Study and Supplementary Self Study problems available on MyLab Accounting.

Within the text we have provided an indication of when it would be appropriate to work each Self Study problem. The detailed solutions for Self Study problems can be found in the print and online Study Guide.

We provide the Supplementary Self Study problems for those who would like additional practice in problem solving. The detailed solutions for the Supplementary Self Study problems are available online, not in the Study Guide.

The .PDF file "Self Study Problems for Volume 2" on MyLab contains the following for Chapter 16:

- 11 Self Study problems,
- 6 Supplementary Self Study problems, and
- detailed solutions for the Supplementary Self Study problems.

# Assignment Problems

(The solutions for these problems are only available in the solutions manual that has been provided to your instructor.)

### *Assignment Problem Sixteen - 1*

***(Transfers To A Corporation Vs. Direct Sale)***

For a number of years, Brett Manson has owned an apartment building in the city of London, Ontario. Information on its acquisition is as follows:

| | |
|---|---|
| Acquisition Cost | $1,355,000 |
| Estimated Cost Of The Land | ( 462,000) |
| Estimated Cost Of The Building | $ 893,000 |

At the beginning of the current year, values related to the property are as follows:

| | |
|---|---|
| Estimated Fair Market Value Of Property | $1,610,000 |
| Estimated Fair Market Value Of Land | ( 574,000) |
| Estimated Fair Market Value Of The Building | $1,036,000 |
| UCC Of The Building | $ 685,022 |

At this time, Brett transfers the property to a corporation using a Section 85 rollover. The value elected for the transfer is $1,147,022 ($462,000 + $685,022). The only consideration received by Brett is common shares in the new corporation.

Later in the year, all of the common shares are sold to Jason Border, an arm's length party, for $1,610,000.

**Required:**

A. Describe the tax consequences for Brett of using Section 85 and selling the common shares.

B. How do these results compare with the tax consequences of simply selling the building directly to Jason Border for $1,610,000?

## Assignment Problem Sixteen - 2

### (Section 85 Rollovers - Short Cases)

The following **independent** cases involve transfers of assets under ITA 85.

**Case One** Depreciable assets with a fair market value of $183,400 are transferred to a corporation in exchange for non-share consideration of $140,000, preferred shares with a fair market value of $22,000 and common shares with a fair market value of $21,400. The assets had a capital cost of $130,000. They were the only assets in their Class and the UCC balance in the Class was $59,904.

**Case Two** Inventories of merchandise are transferred to a corporation in exchange for $93,000 in non-share consideration and $27,000 in common stock (fair market value and legal stated capital). The inventories have a cost of $87,000 and a fair market value of $120,000.

**Case Three** Land is transferred to a corporation in exchange for $72,000 in non-share consideration and $751,000 in common stock (fair market value and legal stated capital). The land cost $617,000 and has a current fair market value of $823,000.

**Required**: For each of the three Cases provide the following information:

A. The minimum and maximum transfer prices that could be elected under the provisions of ITA 85.

B. Assuming the minimum value is elected, the amount of capital gain or business income to be included in the income of the transferor.

C. Again assuming that the minimum transfer value is elected, determine the adjusted cost base and PUC of the preferred and common stock consideration. Your answer should include the determination of any shareholder benefit under ITA 15(1) or deemed dividend under ITA 84(1) that will arise on the transfer, or explain why there is no benefit or deemed dividends.

## Assignment Problem Sixteen - 3

### (ACB Of Consideration And PUC)

Lily Haring has owned a depreciable property for a number of years. The property had an original capital cost of $623,000. It is the only asset in its Class and, at the present time, the UCC for the Class equals $229,663. The current fair market value of the asset is $946,000.

Lily would like to transfer this asset to a new corporation, using the provisions of Section 85(1). She is considering the following alternative consideration packages, all of which total $946,000:

**Package One** Lily will take back debt with a fair market value of $229,663, along with common shares with a fair market value of $716,337.

**Package Two** Lily will take back debt with a fair market value of $100,000, preferred shares with a fair market value of $100,000, and common shares with a fair market value of $746,000.

**Package Three** Lily will take back debt with a fair market value of $700,000 and preferred shares with a fair market value of $246,000.

**Required:** For each of the three packages, determine:

- The minimum transfer value that Lily can elect and the amount and type of income that will result from electing this value.
- The adjusted cost base of each of the items of consideration received by Lily.
- The Paid Up Capital for the preferred and/or common shares issued.

### Assignment Problem Sixteen - 4

#### (ITA 85 Transfer Of Depreciable Asset)

During the current year, Mr. Rob Banting transfers a depreciable capital property to a new corporation. Rob owns all of the shares in the new corporation and it will have a December 31 year end.

The depreciable asset was purchased several years ago for $343,000. The asset has a current fair market value of $420,000. At the time of transfer, it is the only asset in its Class and, prior to the transfer, the balance in the Class was $213,790.

Rob has been carrying forward a $52,000 capital loss on a stock sale. In order to absorb this loss, he elects to transfer the property at a value of $395,000.

As consideration, Rob takes back a note for $175,000, preferred shares with a fair market value of $90,000, and common shares with a fair market value of $155,000.

**Required:** Describe the income tax implications resulting from this transaction. Your answer should include both current tax implications, and the determination of values that will have future tax implications.

### Assignment Problem Sixteen - 5

#### (Short Cases With Gift And Shareholder Benefit)

Peter Kowalski owns a rental property that was acquired years ago at a cost of $1,200,000. At the time, he estimated the value of the land to be $200,000 and the value of the building to be $1,000,000.

Peter estimates that the current value of the property is $1,500,000, with $300,000 of this amount being allocated to the land and $1,200,000 of this amount allocated to the building. As of this date, the UCC of the building is $460,800.

Peter has decided to transfer this property to a corporation using the provisions of Section 85. He is considering three possible scenarios. Consider each of the three scenarios as completely independent.

> **Scenario 1** Peter transfers the property to a new corporation in which he will be the sole shareholder. He has a net capital loss carryforward of $50,000. As he has no other assets with accumulated capital gains, he would like the transfer of the rental property to create a $100,000 capital gain against which he can apply his capital loss. To accomplish this, he elects a transfer value of $300,000 for the land. The elected value for the building will be $460,800. As consideration, he will receive a note payable for $760,800, and preferred shares with a legal stated capital and redemption value of $739,200.

> **Scenario 2** Peter transfers the property to a new corporation in which he will be the sole shareholder. The land is transferred at an elected value of $200,000 and the building is transferred at an elected value of $460,800. As consideration he will receive a note payable for $660,800, and preferred shares with a fair market value (their redemption value) of $939,200. The legal stated capital of the preferred shares will be $839,200.

> **Scenario 3** Peter's daughter, Stella, establishes a new corporation with an investment of $10,000 of her own money for the corporation's common shares. Peter transfers the rental property to this corporation with an elected value of $200,000 for the land and $460,800 for the building. As he would like to provide financial assistance for his daughter, in his election he claims that the fair market value of the land is $200,000, hoping that the CRA will not look at the fact that this value is too low. Based on this, he only takes back $1,400,000 in consideration, a note payable for $400,000 and preferred shares with a legal stated capital and a redemption value of $1,000,000.

On review, the CRA discovers the undervaluation and reassesses Peter on the basis that the land actually had a fair market value of $300,000. Peter does not object to this reassessment.

**Required:** For each of the preceding scenarios, determine for Mr. Kowalski:

- The tax consequences of the transfer for him.
- The tax cost of the land and building in the hands of the corporation.
- The adjusted cost base of the shares issued to him by the corporation.
- The PUC of the shares issued to him by the corporation.

In your solution for Scenario 3, include the effects of the CRA reassessment.

## *Assignment Problem Sixteen - 6*

### *(ITA 85 Transfer With Sale/Redemption Of Shares)*

Three years ago, Connie Bright acquired a commercial property consisting of land and a building at a total cost of $1,475,000. At the acquisition date, an appraisal concluded that the respective values for the two components of the property were $300,000 for the land and $1,175,000 for the building. The acquisition was facilitated by a $550,000 mortgage on the property.

During 2017 and 2018, she operated the property as a proprietorship with good success, realizing a substantial profit in each year. Given this, she would like to transfer the property to a corporation as of January 1, 2019. On that date, the relevant facts about the property are as follows:

| | Land | Building |
|---|---|---|
| Fair Market Value | $475,000 | $1,300,000 |
| Adjusted Cost Base/Capital Cost | 300,000 | 1,175,000 |
| UCC | N/A | 1,071,365 |
| Mortgage Balance | N/A | 525,000 |

Connie will elect a transfer value for the land of $475,000. The corresponding figure for the building will be $1,100,000.

The corporation will assume the $525,000 mortgage on the building and, in addition, will issue a note to Connie for $1,050,000. The corporation will also issue common shares to Connie with a fair market value of $200,000 and legal stated capital of $200,000.

The new corporation does not have a balance in its General Rate Income Pool (GRIP) account in any of the years under consideration.

**Required:**

A. What are the tax consequences of making this transfer at the elected value of $1,575,000 ($475,000 + $1,100,000)? Your answer should include amounts to be included in Connie's income as a result of the transfer, as well as the corporation's tax values for the assets.

B. Compute the adjusted cost base of each component of the consideration that Connie has received from the corporation.

C. Compute the PUC of the corporation's newly issued common shares.

D. What amounts would be included in Connie's Net Income For Tax Purposes if, during 2019, she sells her common shares for $400,000?

E. What amounts would be included in Connie's Net Income For Tax Purposes if, during 2019, the corporation redeems her common shares for $400,000?

### Assignment Problem Sixteen - 7

#### (Transfers To A Corporation And Sale/Redemption Of Shares)

For a number of years, Martin Flex has owned land with a building situated on it. He has operated several different businesses from this venue.

The cost of the property for Martin was $2,800,000, with $525,000 of this amount being allocated to land and the $2,275,000 balance allocated to the building. In order to assist with the purchase of this property, Martin acquired a $1,000,000 mortgage.

He is in the process of starting a new business and would like to use the provisions of ITA 85(1) to transfer the property to a new corporation, Flexor Inc. The new corporation will have a December 31 year end.

The transfer will take place on January 1, 2019. At that time, information on the property is as follows:

| | |
|---|---|
| • Fair Market Value Of The Land | $ 720,000 |
| • Fair Market Value Of The Building | 2,600,000 |
| • UCC Of The Building | 1,893,618 |
| • Mortgage Balance | 872,000 |

In implementing the ITA 85(1) rollover, Martin will elect a value of $525,000 for the land and $1,975,000 for the building. The corporation will assume the $872,000 balance on the mortgage and will issue new debt to Martin in the amount of $1,128,000. Martin will also receive common shares with a fair market value of $1,320,000.

This total consideration of $3,320,000 ($872,000 + $1,128,000 + $1,320,000) is equal to the $3,320,000 ($720,000 + $2,600,000) fair market value of the land and building.

There are no additions to Flexor Inc.'s General Rate Income Pool during 2019.

**Required:**

A. What are the tax consequences of making this transfer at the elected value of $2,500,000 ($525,000 + $1,975,000)? Your answer should include amounts to be included in Martin's income as a result of the transfer, as well as the corporation's tax values for the assets.

B. Compute the adjusted cost base of each component of the consideration that Martin has received from the corporation.

C. Compute the PUC of the corporation's newly issued common shares.

D. What amounts would be included in Martin's Net Income For Tax Purposes if, during 2019, he sells his common shares for $1,320,000?

E. What amounts would be included in Martin's Net Income For Tax Purposes if, during 2019, the corporation redeems his common shares for $1,320,000?

### Assignment Problem Sixteen - 8

#### (Transfers To A Corporation And Share Redemption)

Ms. Martha Fleck owns an unincorporated business that she operates out of leased premises. In order to simplify record keeping, her general accounting information is the same as that which she uses for tax purposes. On December 31, 2018, the business has the following assets and liabilities.

| | Tax Value | Fair Market Value |
|---|---|---|
| Accounts Receivable | $132,000 | $ 127,500 |
| Inventory | 261,000 | 312,000 |
| Equipment (Cost = $420,000) | 351,000 | 475,500 |
| Goodwill | Nil | 525,000 |
| Total Assets | $744,000 | $1,440,000 |
| Liabilities | ( 142,500) | ( 142,500) |
| Net Assets | $601,500 | $1,297,500 |

All of the assets of the unincorporated business will be transferred to Rollex Inc., a new corporation established for the purpose of this transfer. The Accounts Receivable have a face value of $132,000 and will be transferred using the ITA 22 joint election.

The remaining assets will be transferred under the provisions of ITA 85(1). The total consideration received by Ms. Fleck will have a value of $1,312,500 ($1,440,000 - $127,500), the fair market value of the assets other than Accounts Receivable. The consideration is made up of new debt of $112,500, assumption of the old debt of $142,500, preferred stock with a fair market value of $337,500, and common stock with a fair market value of $720,000.

The new corporation does not have a balance in its General Rate Income Pool (GRIP) account in any of the years under consideration.

Ms. Fleck wishes to incorporate her business in a manner that minimizes or eliminates any tax effects resulting from the transaction.

**Required:** Ignore the lifetime capital gains deduction in your solution.

A. Do you agree with the decision to transfer the accounts receivable using ITA 22? Explain your conclusion and determine the tax consequences of this decision.

B. Given that Ms. Fleck wishes to minimize or eliminate current taxes, indicate the values that should be elected for each of the assets to be transferred.

C. Determine the adjusted cost base of the debt, preferred shares, and common shares that would be received by Ms. Fleck on the rollover.

D. Determine the Paid Up Capital of the common stock and preferred stock that were issued by the new corporation to Ms. Fleck.

E. Determine the tax consequences to Ms. Fleck if the preferred and common shares that she received in the rollover were immediately redeemed in January, 2019 by the new corporation at fair market values.

### Assignment Problem Sixteen - 9

#### (Gift To Related Party - Section 85)

Ms. Martine Renaud has operated an unincorporated business for over 25 years. The business has been very successful and, on January 1, 2019, its assets and liabilities have tax values and estimated fair market values as follows:

| | Tax Value | Fair Market Value |
|---|---|---|
| Accounts Receivable (No Reserve Taken) | $ 60,000 | $ 57,000 |
| Inventories | 825,000 | 840,000 |
| Depreciable Assets - CCA Class 8 (Note One) | 1,725,000 | 1,780,000 |
| Land | 923,000 | 1,450,000 |
| Building (Note Two) | 1,760,000 | 2,436,000 |
| Total Assets | $5,293,000 | $6,563,000 |
| Liabilities | ( 430,000) | ( 430,000) |
| Net Assets (Owner's Equity) | $4,863,000 | $6,133,000 |

**Note One** The capital cost of the assets in Class 8 total $1,960,000.

**Note Two** The capital cost of the Building is $3,600,000.

Ms. Renaud has two daughters, Alma aged 26 and Amanda aged 28. Currently, they are both unemployed but, thanks to Ms. Renaud's generosity over the years, they both have significant assets and a comfortable lifestyle.

Ms. Renaud would like to transfer the future growth in her business to her daughters. To accomplish this, in December, 2018, she arranges for them to establish a new corporation through the investment of $10,000 each. Each daughter receives 100 common shares. The new corporation is named Almand Inc. and at this point, the corporation has no assets other than the $20,000 invested by the two daughters.

On January 1, 2019, Ms. Renaud transfers all of the assets of her unincorporated business to Almand Inc. The Accounts Receivable are transferred to the corporation using the ITA 22 joint election. The remaining assets are transferred under the provisions of ITA 85(1). The business does not have goodwill.

Ms. Renaud transfers the assets at an elected value of $5,233,000 ($5,293,000 - $60,000), the total tax value of the assets other than Accounts Receivable. Almand Inc. assumes all of the $430,000 in liabilities of Ms. Renaud's unincorporated business and issues new debt to her in the amount of $1,570,000.

In addition, she receives redeemable preferred shares with a fair market value and legal stated capital of $4,506,000, a total of $6,506,000.

The CRA issues a reassessment related to the rollover transaction in November, 2019. It is based on a fair market value for the land of $1,850,000, $400,000 more than Ms. Renaud's estimate of $1,450,000. Ms. Renaud does not file an objection to the reassessment as her father, a retired appraiser, has advised her she would ultimately lose after paying outrageous accounting fees.

**Required:** Ignore the lifetime capital gains deduction in your solution.

A. Taking into consideration the effect of the reassessment, determine the tax consequences to Ms. Renaud that result from the transfer of her business assets to Almand Inc. Your answer should include amounts to be included in Ms. Renaud's income as a result of the transfer and the reassessment, as well as the adjusted cost base and PUC of her preferred shares.

B. Determine the tax consequence to Ms. Renaud if Almand Inc. redeems her preferred shares for $4,506,000 immediately after the reassessment.

C. Alma finds that she cannot tolerate being a 50 percent shareholder in a corporation with her sister. She sells her Almand Inc. shares to an arm's length party for $275,000 immediately after the reassessment. Determine the tax consequences of this sale for Alma.

### Assignment Problem Sixteen - 10

**(Excess Consideration)**

For the last 10 years, Matthew Garnet has operated Garnet Enterprises as a sole proprietorship. As he no longer needs all of the income that is produced by the business, he would like to transfer the business to Garnet Ltd., a corporation in which he holds 100 percent of the outstanding common shares. This corporation has a December 31 year end.

The transfer takes place on January 1, 2018. Mr. Garnet uses ITA 85(1) to transfer any tangible assets with fair market values in excess of their tax values (adjusted cost base or UCC). These assets, and their relevant values on the date of transfer are as follows:

| | Tax Value | Estimated Fair Market Value |
|---|---|---|
| Depreciable Assets - CCA Class 8 (Note One) | \$ 72,000 | \$ 106,500 |
| Land | 127,500 | 247,500 |
| Building (Note Two) | 414,000 | 748,000 |
| Net Assets (Owner's Equity) | \$613,500 | \$1,102,000 |

**Note One** The capital cost of the assets in Class 8 is \$106,500.

**Note Two** The capital cost of the Building is \$567,000.

As consideration, Mr. Garnet will receive a note for \$1,102,000 and preferred shares with a nominal value. His elected value will be \$1,102,000, the fair market value of the non-share consideration. The elected value for the individual assets transferred will be their estimated fair market values.

In 2019, Matthew is reassessed on the basis that the building's fair market value is only \$648,000. He accepts the reassessment without objection. The CRA accepts the estimated values for the land and the Class 8 assets, resulting in a total fair market value of \$1,002,000 (\$106,500 + \$247,500 + \$648,000).

**Required:**

A. Calculate the effect on Mr. Garnet's Net Income For Tax Purposes that will result from his transfer of the Garnet Enterprises' assets to Garnet Ltd. in 2018.

B. Describe the tax consequences of the reassessment. Include in your answer the adjusted cost base of the consideration, and the adjusted cost base and the PUC of the preferred shares after the reassessment.

C. Indicate the tax values that will be recorded for the assets that are transferred to Garnet Ltd. under ITA 85(1) after the reassessment.

### Assignment Problem Sixteen - 11

**(Dividend Stripping)**

A number of years ago, Sheila Hicks established a new corporation, Hicks Ltd., with an investment of \$250,000. In return for this investment, she received 12,500 common shares in the new corporation. As Sheila, a Canadian resident, is the only shareholder, Hicks qualifies as a Canadian controlled private corporation.

The corporation has a December 31 year end.

Both the adjusted cost base and the PUC of the Hicks common shares is equal to Sheila's investment of \$250,000. There have been no changes in the number of shares issued and outstanding since Hicks Ltd. was incorporated.

As the business has enjoyed great success since its inception, it is estimated that the current value of Sheila's shares is $3,200,000. As she has more than enough resources to live comfortably for the rest of her life, she would like to freeze the current value of the Hicks Ltd.'s shares and have any future increases in the Company's value accrue to her 35 year old son, Brandon Hicks.

To accomplish this goal, she will have Brandon incorporate a new company, Brandon Inc. and acquire all of its common shares with a nominal amount of his own money.

Once Brandon Inc. is incorporated in February, 2019, she will use the provisions of ITA 85(1) to transfer all of her Hicks Ltd. shares to that Company. As Hicks Ltd. is a qualified small business corporation, she would like to structure the rollover in a manner that would utilize her remaining lifetime capital gains deduction.

While she has used this tax benefit in the past, for 2019, she has an unused balance of $426,000. In order to accomplish this goal, she plans to make the transfer at an elected value of $676,000 ($250,000 + $426,000), taking back an interest bearing note with a fair market value of $676,000, and retractable preferred shares with a fair market value and a PUC of $2,524,000.

Neither of the Companies would have a balance in their General Rate Income Pool (GRIP) account in any of the years under consideration.

**Required:**

A. Explain the tax consequences of the proposed ITA 85(1) transfer of the Hicks Ltd. shares to Brandon Inc.

B. While still accomplishing the goal of freezing her estate, indicate how Sheila could alter the rollover transaction in a manner that would reduce or eliminate the Tax Payable required under her proposed structure. Determine the tax implications that would result from this new approach.

C. As an alternative approach to using her lifetime capital gains deduction, Sheila proposes selling 2,641 Hicks Ltd. common shares to Brandon Inc. for cash. The shares would be sold for their current fair market value and this would produce, in the absence of ITA 84.1, a capital gain of just over $426,000. Explain the tax consequences of this proposed transaction.

Show all calculations required to support your answers.

### *Assignment Problem Sixteen - 12*

***(Dividend Stripping)***

Daryl Foster has operated Foster's Fasteners Inc. for the last 15 years. It is a Canadian controlled private corporation that is involved in the sale of luxury hardware items. His original investment when the Company was established was $780,000. Daryl is the only shareholder and the $780,000 is both the adjusted cost base and the PUC of his shares.

As the Company has been very profitable since its inception, its shares have a current fair market value of $6,200,000.

As Daryl is nearing retirement age, he would like to extract a significant amount of funds from his corporation without incurring a great deal of taxation. He has discussed this matter with Thornton Brockton, his self-trained accountant of many years. While Thornton has never implemented such a strategy, he indicates that he has heard of a procedure called a Section 85 rollover that will allow Daryl to transfer his shares to a new corporation using an elected value that will create a capital gain of $600,000. As this is the amount of Daryl's unused lifetime capital gains deduction, Thornton advises Daryl that he can receive the original cost of his shares, plus a $600,000 capital gain on a tax free basis.

Using Section 85, Daryl will transfer all of the shares of Foster's Fasteners to Foster Investments, a new Company in which Daryl will hold all of the shares. The elected value for the transfer will be $1,380,000.

In return, Daryl will receive a non-interest bearing note for $1,380,000, plus Foster Investment shares with a redemption value of $4,820,000. Given the cash resources of Foster's Fasteners, this Company's shares should be able to pay sufficient dividends to Foster Investments to allow the payment of the note within one or two years.

Neither of the Companies have a balance in their General Rate Income Pool (GRIP) account in any of the years under consideration.

**Required:**

A. In the absence of ITA 84.1, indicate the tax consequences of the transfer of the shares of Foster's Fasteners to Foster Investments.

B. Determine whether ITA 84.1 would be applicable in this case. Assuming that ITA 84.1 is applicable, calculate the deemed dividend that would arise on this transfer. In addition, indicate the net economic effect that would result from this transfer combined with a redemption of the Foster Investments shares at their fair market value of $4,820,000.

## Assignment Problem Sixteen - 13

### (Capital Gains Strips)

From its original incorporation, Doldem Inc. has always been a Canadian controlled private corporation. For the last 5 years, it has owned 100 percent of the outstanding shares of Darco Ltd. Darco is also a Canadian controlled private corporation. The shares were acquired at a cost of $1,650,000. This is also the PUC of the Darco shares.

The Darco shares have been a very successful investment for Doldem Inc. Reflecting this, it is estimated that their fair market value on January 1, 2019 is $4,700,000. During the period during which Doldem has held the Darco shares, the subsidiary has accumulated safe income of $893,000.

Doldem does not have a balance in its RDTOH account. Neither company has a General Rate Income Pool (GRIP) balance.

**Required:** Indicate the amount, and type, of income that would accrue to Doldem Inc. in both of the following **independent** situations:

A. Darco Ltd. obtains a bank loan in the amount of $3,050,000 and uses all of the acquired funds to pay a dividend to Doldem Inc. Subsequent to the receipt of this dividend, Doldem Inc. sells the Darco shares to Ms. Laraz, an arm's length party, for $1,650,000.

B. Using ITA 85(1), Doldem transfers the Darco shares to Laraz Ltd., an unrelated corporation. The elected value is $1,650,000. In return for the Darco shares, Doldem receives Laraz Ltd. preferred stock with a PUC of $1,650,000 and a redemption value of $4,700,000. Immediately after the transfer, Laraz Ltd. redeems the preferred stock for $4,700,000.

# CHAPTER 17

# Other Rollovers And Sale Of An Incorporated Business

## Introduction

17-1. The preceding Chapter gave detailed consideration to the Section 85 rollover provisions, which provide for a tax deferred transfer of property to a corporation. In addition, Chapter 9 dealt with rollovers involving transfers to a spouse and transfers of farm property to children. There are a number of other rollover provisions in the *Act* that will be discussed in this Chapter.

17-2. These additional rollover provisions cover share for share exchanges among corporations, share exchanges in the process of the reorganization of a corporation, amalgamations of existing corporations, the winding-up of a 90 percent or more owned subsidiary, and conversions of debt to shares. The winding-up of a Canadian corporation that is not a 90 percent owned subsidiary is also covered. This latter transaction does not involve a rollover, but is dealt with in the same Section of the *Income Tax Act* as the winding-up of a 90 percent or more owned subsidiary.

## Share For Share Exchanges - ITA 85.1

### Background

17-3. ITA 85.1 provides for a rollover in which a shareholder (vendor) exchanges his shares for shares of an acquiring corporation (purchaser). When there are many diverse shareholders, a share for share exchange is easier to accomplish than a Section 85 rollover, because there is no need for each shareholder to file an election. Further, the provisions of ITA 85.1 apply automatically, unless the vendor includes any gain or loss on the transaction in his income tax return. Given these features, an ITA 85.1 exchange is an important arrangement in business combination transactions.

### General Rules

17-4. The general rules for this rollover apply automatically unless the vendor opts to include a gain or loss from the transaction in their income tax return. These general rules are as follows:

**ITA 85.1(1)(a)** The vendor (acquiree) is deemed to have:

(i) disposed of the exchanged shares for proceeds of disposition equal to their adjusted cost base.
(ii) acquired the shares of the purchaser at a cost to the vendor equal to the adjusted cost base to the vendor of the exchanged shares immediately before the exchange.

**ITA 85.1(1)(b)** The cost to the purchaser (acquirer) of each of the acquired shares is deemed to be the lesser of:

(i) its fair market value immediately before the exchange, and
(ii) its paid-up capital immediately before the exchange.

**ITA 85.1(2.1)** The PUC of the purchaser shares that have been issued to the vendor is limited to the PUC of the shares given up by the vendor.

17-5. You should note that the ITA 85.1(1)(b) provision may be problematical for the purchaser in situations where the adjusted cost base of the vendor's shares exceeds their PUC. If the shares are later sold by the purchaser, that excess of the adjusted cost base over the PUC will be subject to tax as a capital gain since the purchaser's adjusted cost base will be equal to the PUC. This would suggest that, in situations where the adjusted cost base of the shares exceeds their PUC, it might be better to use ITA 85(1) for the transfer.

## Conditions For The Application Of ITA 85.1

17-6. The conditions required for this rollover to be applicable are found in ITA 85.1(1) and (2). To begin, the vendor's shares must be held as capital property. Additional conditions for the applicability of the rollover are as follows:

**ITA 85.1(2)(a)** The vendor and purchaser must be dealing with each other at arm's length.

**ITA 85.1(2)(b)** The vendor, or persons with whom he does not deal at arm's length, cannot control the purchaser immediately after the exchange. Likewise, they cannot own shares having a fair market value in excess of 50 percent of the total fair market value of the purchasing corporation's outstanding shares.

**ITA 85.1(2)(c)** The vendor and purchaser cannot have filed an election under ITA 85(1) with respect to the exchanged shares.

**ITA 85.1(2)(d)** The vendor must not have received any consideration, other than shares of the purchaser, in return for the shares given up in the exchange.

17-7. You should note that this last condition under ITA 85.1(2)(d) does not prevent the vendor from selling additional shares to the purchaser for non-share consideration.

## Example

### *Application Of ITA 85.1*

17-8. A brief example will serve to illustrate the basic provisions of ITA 85.1:

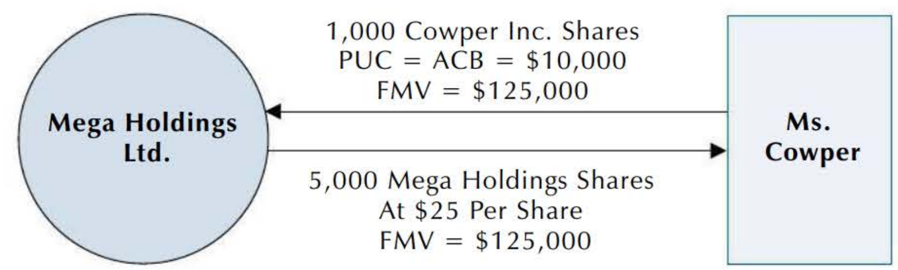
**EXAMPLE** Ms. Cowper is the sole shareholder of Cowper Inc., owning a total of 1,000 shares with a Paid Up Capital (PUC) and an adjusted cost base of $10,000. The shares of Cowper Inc. have a current fair market value of $125,000.

Mega Holdings Ltd. acquires these shares in return for 5,000 of its common shares. The Mega Holdings shares are currently trading at $25 per share, resulting in a total value for the 5,000 shares of $125,000.

**ANALYSIS** The information in the example is presented graphically in Figure 17-1.

In the absence of the share for share exchange provisions in ITA 85.1, Ms. Cowper would have a capital gain of $115,000 ($125,000 - $10,000). However, under the rollover provisions of ITA 85.1, the following results apply:

**Figure 17 - 1**
**ITA 85.1 Example**




- Ms. Cowper is deemed to have disposed of her shares for an amount equal to the $10,000 adjusted cost base of the Cowper Inc. shares. This means that there is no capital gain on the disposition. [ITA 85.1(1)(a)(i)]
- Ms. Cowper is deemed to have acquired the shares in Mega Holdings Ltd. at a cost equal to the adjusted cost base of the Cowper Inc. shares, or $10,000. [ITA 85.1(1)(a)(ii)]
- The adjusted cost base of the Cowper shares acquired by Mega Holding Ltd. is deemed to be equal to $10,000, the lesser of their fair market value of $125,000, and their PUC of $10,000 [ITA 85.1(1)(b)]. You should note that this limit applies, even in situations where the vendor opted to forego the rollover under ITA 85.1 by including the gain in income (see Paragraph 17-9).
- The PUC of the Mega Holding Ltd. shares that have been issued to Ms. Cowper is limited to the $10,000 PUC of the Cowper shares that have been given up. [ITA 85.1(2.1)]

### *Opting Out Of ITA 85.1*

17-9. As we have noted, ITA 85.1 applies automatically unless the vendor opts out in their income tax return. In this example, Ms. Cowper could opt out of ITA 85.1 by including the taxable capital gain of $57,500 [(1/2)($125,000 - $10,000)] in her income tax return. Note that, unlike the situation when ITA 85(1) is used in a rollover, there is no flexibility on the transfer value. With respect to the shares that are exchanged, opting out requires that 100 percent of the capital gain on the exchanged shares be included in income. This could be a problem if, for example, Ms. Cowper only wanted to recognize part of the gain on her shares.

17-10. There are two possible solutions to this problem. The transfer of Ms. Cowper's shares could be made using the provisions of ITA 85(1). This would allow the use of an elected value that would limit the amount of gain that would be recognized.

17-11. An alternative, perhaps simpler solution, would be to sell a portion of her shares to Mega Holdings for cash. This would allow the recognition of the desired amount of capital gain. The remaining shares could then be exchanged on a tax free basis under ITA 85.1.

## Exercise Seventeen - 1

**Subject:** Share For Share Exchange

Ms. Aly Alee is the sole shareholder of Aayee Ltd., a Canadian controlled private corporation that is not a qualified small business corporation. The corporation was established several years ago by Ms. Alee with an investment of $450,000. It has identifiable net assets with a fair market value of $2,200,000. The shares of her company are acquired by a large publicly traded company, Global Outreach Inc., through the

issuance of 50,000 new shares. At the time of this business combination, the Global Outreach Inc. shares are trading at $49 per share. Indicate the tax consequences of this transaction to both Ms. Alee and Global Outreach Inc.

**SOLUTION available in print and online Study Guide.**

### ITA 85.1 In Practice

17-12. We have illustrated ITA 85.1 using an example that involves a large public company acquiring a corporation with a single shareholder. This is not the usual application of ITA 85.1. ITA 85.1 was designed to be used in situations where a public company acquires a widely held corporation with a large number of shareholders.

17-13. As noted in Paragraph 17-3, Section 85 can be used as an alternative to Section 85.1. However, in situations where the acquiree has a large number of shareholders, this approach would require the filing of numerous, in some cases hundreds, of separate Section 85 elections. The use of Section 85.1 avoids this by making its application automatic, unless the acquiree includes any gain or loss in income. This is a much more efficient procedure in most business combination situations.

**We suggest you work Self Study Problems Seventeen-1 and 2 at this point.**

# Exchange Of Shares In A Reorganization - ITA 86

**BYRD/CHEN NOTE** ITA 86 has been widely used in the implementation of estate freezes, a procedure used to transfer the future growth in a private corporation to the spouses, children, or other parties related to the principal shareholder of a CCPC. The 2018 expansion of the applicability of the Tax On Split Income (TOSI) has made this a much more difficult procedure to implement effectively. When the TOSI is applicable, both dividends and capital gains received as a result of this procedure will be subject to taxation at the maximum federal rate, removing most or all of the incentive for undertaking an estate freeze.

More specifically, the TOSI will always be applicable to income received by children under 18. In addition, it will be generally applicable to other related individuals unless the income they receive is an Excluded Amount. If they are 18 or over and actively involved in the business, the income can escape the TOSI as the corporation may be an Excluded Business. If they are 25 or over and own at least 10 percent of the CCPC's outstanding shares in terms of both fair market value and voting rights, the income can escape the TOSI as their holding will be viewed as Excluded Shares. See Chapter 11 for a more detailed discussion of these concepts.

There are other applications of ITA 86, a common one being transfers of ownership to a key employee or group of employees. In general, these other procedures will not result in the application of the TOSI.

In our coverage of ITA 86, we will assume that the TOSI is not applicable. To make this more realistic we will avoid applications involving minor children and non-voting shares. However, it is important that you recognize that the use of the Section 86 in estate freezes is limited by the possible application of the TOSI.

## Application Of ITA 86(1)

### Basic Procedure

17-14. ITA 86(1) applies when there has been a reorganization involving an exchange of shares within a single corporation. In the usual application, a shareholder of a corporation exchanges shares held in at least one class of existing shares, for authorized shares in the same company, or for authorized shares in the same company combined with non-share

consideration (note that the authorized shares must be of a different class than the existing shares). In effect, there is a redemption of the taxpayer's current shareholding, combined with an acquisition of a new shareholding. As long as non-share consideration is within acceptable limits, ITA 86(1) allows this transaction to take place without tax consequences to the taxpayer whose shares are being redeemed.

### Use In Estate Freeze

17-15. One of the most common applications of ITA 86(1) is in an estate freeze, where an owner of a business wishes to pass on the future growth of the business to adult family members who have been actively engaged in the business.

> **EXAMPLE** A father holds all of the outstanding common shares of a corporation. These shares have a fair market value in excess of their adjusted cost base and, as a consequence, their sale or redemption would normally result in a deemed dividend and/or a capital gain or capital loss. Further, if the father continues to hold the shares, future growth in the corporation will accrue to him.

> **ANALYSIS** To avoid this situation, the father will exchange his common shares for newly issued preferred shares of the corporation. The preferred shares will have a fixed redemption value equal to the fair market value of the common shares given up. The fact that their value is fixed will serve to freeze the value of the father's interest in the corporation. If the father wishes to retain control of the corporation, the preferred shares can be structured to provide voting rights sufficient to achieve this objective. Common shares will then be issued to a spouse, a child, or some other related person.

17-16. As the preferred shares held by the father reflect the full fair market value of the company, the new common shares can be issued to the related person at a fairly nominal value. However, any future growth in the value of the company will accrue to these common shares. ITA 86(1) provides for the father's exchange of shares to take place on a rollover or tax free basis (see Chapter 19 for a more detailed discussion of estate freezes). Note that the ITA 86 rollover differs from the ITA 85(1) rollover in that there are no elected amounts and no election form to be filed.

## Conditions For The Reorganization

### General Conditions

17-17. For the provisions of ITA 86(1) to apply, several conditions must be met.

> **Shares Must Be Capital Property** First, the original owner's shares must be capital property to the owner. They cannot be part of an inventory of securities that is being held for trading purposes.

> **All Shares Held By Transferor In A Particular Class** A second condition is that the transaction must result in an exchange of all of the outstanding shares of a particular class that are owned by the transferor. For example, all Class A common shares that are owned by the transferor must be exchanged for some other type of share. Note that there is no requirement that Class A common shares that are held by other shareholders be exchanged as part of the transaction. Further, it is not necessary that other classes of shares owned by the transferor be exchanged for new shares.

> **Reorganization Of Capital** A third condition is that the share exchange must be integral to a reorganization of the capital of the corporation. This will often require that the articles of incorporation be amended to authorize any new class of shares.

> **Transferor Must Receive Shares** A final condition is that the transferor must receive shares of the capital stock of the corporation. While this does not preclude the transferor from receiving non-share consideration, such non-share consideration should not exceed the adjusted cost base or the PUC of the shares transferred. If it does, the excess will have to be taken into income as a deemed dividend and either a taxable capital gain or an allowable capital loss.

### Establishing Market Value For Preferred Shares

17-18. In the more common applications of ITA 86(1), the new shares received by the transferor will usually be preferred shares. These shares must be designed in such a fashion as to clearly establish their fair market value. If this is not the case, a subsequent dispute with the CRA could result in some of the benefits of using ITA 86(1) being lost. Adding the following characteristics to the preferred shares will serve to establish a defensible fair market value:

- The preferred shares must be redeemable at the option of the shareholder. The CRA rigorously enforces this requirement to protect the fair market value of the preferred shares.
- The preferred shares should be entitled to a dividend at a reasonable rate. Without a reasonable dividend entitlement to the original shareholder, the incoming shareholders could benefit by receiving a disproportionate share of the corporation's future profits. However, there is no requirement for the entitlement to be cumulative.
- The corporation must guarantee that dividends will not be paid on any other class of shares, if the payment would result in the corporation having insufficient net assets to redeem the preferred shares at their specified redemption price.
- The preferred shares must become cumulative if the fair market value of the net assets of the corporation falls below the redemption value of the preferred shares, or if the corporation is unable to redeem the shares on a call for redemption.
- The preferred shares may or may not have normal voting rights. However, they should carry votes on any matter regarding the rights attached to the preferred shares.
- The preferred shares should have preference on liquidation of the corporation. While the very nature of preferred shares tends to guarantee preference, the CRA requires additional assurance that the normal provisions for such shares will not be avoided.

## Procedures

### General Rules

17-19. As noted previously, an ITA 86(1) reorganization involves a redemption (disposition) of a given shareholder's holding of a particular class of shares (old shares, hereafter). In return, the shareholder acquires shares of a different class (new shares, hereafter) and, in some reorganizations, non-share consideration. ITA 86(1) specifies a number of rules that apply in such a reorganization of capital. These are as follows:

**Non-Share Consideration** ITA 86(1)(a) indicates that the cost to the shareholder of this consideration is deemed to be its fair market value.

**Cost Of New Shares** ITA 86(1)(b) indicates that the cost of the new shares to the shareholder is equal to the cost of the old shares, less any non-share consideration received.

**Proceeds Of Redemption For Old Shares** Because there is a redemption of shares, there is the possibility of an ITA 84(3) deemed dividend. ITA 84(3)(a) defines such dividends as the excess of the "amount paid" over the PUC of the shares being redeemed. This "amount paid" clearly includes any non-share consideration and, when shares are included in the redemption payment, ITA 84(5)(d) indicates that their value is based on any increase in PUC resulting from the issuance of these shares. Putting this together leads to the conclusion that the total proceeds for the redemption will be equal to the non-share consideration plus the PUC of any new shares issued. Note that, in the usual ITA 86(1) scenario, the PUC of the new shares will often be reduced by a PUC reduction under ITA 86(2.1)(a). (See Paragraph 17-20.)

**Proceeds Of Disposition For Old Shares** As the redemption of the old shares is a type of disposition, there is also the possibility of a capital gain or loss. For the purposes of determining the capital gain or loss on this disposition, ITA 86(1)(c) defines the proceeds of disposition for the old shares as being equal to the cost of the new shares (the cost of the old shares, less non-share consideration), plus any non-share consideration received by the taxpayer.

In our general discussion of ITA 84(3) redemptions in Chapter 14, we discuss the possibility that the combination of redemption procedures and disposition procedures could result in the double counting of all or part of any gain on the transaction. As we noted there, this possibility is eliminated by the fact that the ITA 54 definition of proceeds of disposition excludes ITA 84(3) dividends.

### PUC Reduction Calculation

17-20. As noted in the preceding rules, a PUC reduction may be required on the new shares. This is specified in ITA 86(2.1)(a). This reduction is calculated as follows:

| | | |
|---|---|---|
| Increase In Legal Stated Capital Of New Shares | | $xx,xxx |
| Less The Excess, If Any, Of: | | |
| PUC Of Old Shares | ($x,xxx) | |
| Over The Non-Share Consideration | x,xxx | ( x,xxx) |
| ITA 86(2.1)(a) PUC Reduction | | $xx,xxx |

17-21. In reviewing this PUC reduction formula, note that where the non-share consideration is equal to, or greater than the PUC of the old shares, the amount subtracted from the increase in the legal stated capital of the new shares will be nil. This means that the PUC reduction will be equal to the increase in legal stated capital for the new shares. In common sense terms, if the shareholder takes back the full amount of the old PUC in the form of non-share consideration, the PUC of the new shares will be nil.

17-22. As was the case with rollovers to a corporation under Section 85, if the PUC reduction applies to more than one class of shares, it will generally be allocated to the individual classes on the basis of the relative fair market value of each class.

## Example Using ITA 86(1) In An Estate Freeze

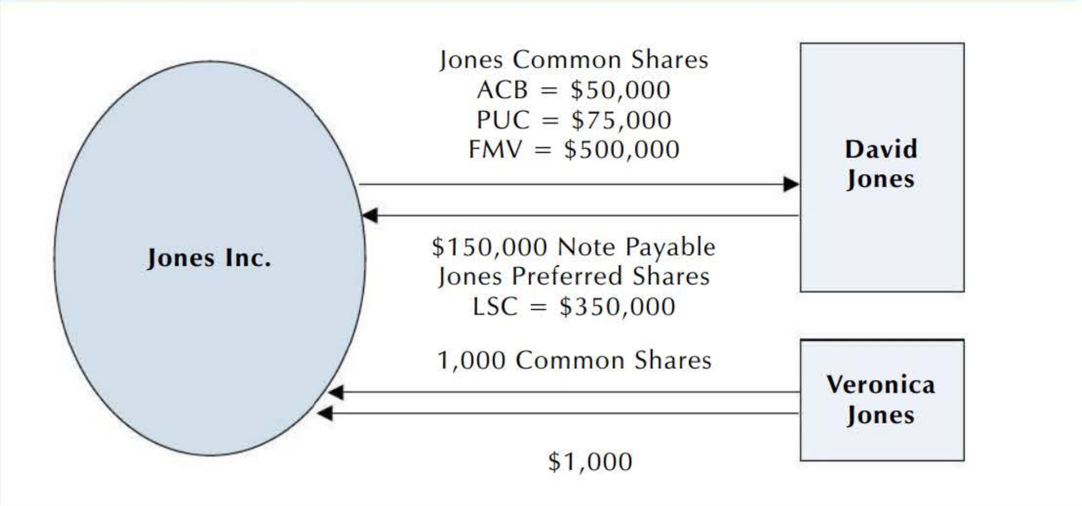
### Basic Data

17-23. An example will serve to illustrate the ITA 86(1) procedures. You might note that the example illustrates the manner in which an ITA 86(1) reorganization of capital can be used to freeze the value of an individual's estate. The example is illustrated graphically in Figure 17-2 (following page).

**EXAMPLE** Mr. David Jones owns all of the outstanding shares of Jones Inc. These common shares have an adjusted cost base of $50,000 and a paid up capital of $75,000. Because of the successful operations of the Company, the current fair market value of these common shares is $500,000.

Mr. Jones would like to have future growth in the value of the corporation accrue to his daughter, Ms. Veronica Jones. Veronica is 30 years old and has been actively and substantially involved in the business for over 5 years. To accomplish this, Mr. Jones exchanges his common shares for a $150,000 note payable from the corporation and preferred shares with a fair market value and a legal stated capital of $350,000. Common shares are purchased by Veronica Jones for $1,000. These are the only Jones Inc. common shares outstanding subsequent to these transactions.

**Figure 17 - 2 ITA 86(1) Example**




## PUC Reduction

17-24. The first step in applying the ITA 86(1) rules in this situation would be to calculate the required PUC reduction and the resulting PUC value for the preferred shares. As the non-share consideration of $150,000 exceeds the $75,000 PUC of the shares given up, we would expect the PUC reduction formula to reduce the PUC of the preferred shares to nil. The following calculations support this expected result:

| | | |
|---|---|---|
| Cost Of Non-Share Consideration (Note Payable) | | $150,000 |
| | | |
| Legal Stated Capital Of Preferred Shares | | $350,000 |
| Less The Excess, If Any, Of: | | |
| PUC Of Shares Given Up | ($ 75,000) | |
| Over The Non-Share Consideration | 150,000 | Nil |
| ITA 86(2.1)(a) PUC Reduction | | $350,000 |
| | | |
| Legal Stated Capital Of Preferred Shares | | $350,000 |
| ITA 86(2.1)(a) PUC Reduction | | ( 350,000) |
| PUC Of Preferred Shares | | Nil |

## Other Calculations

17-25. Other required values can be calculated as follows:

| | |
|---|---|
| Adjusted Cost Base Of Shares Given Up | $ 50,000 |
| Non-Share Consideration | ( 150,000) |
| Adjusted Cost Base Of Preferred Shares | Nil |
| | |
| PUC Of Preferred Shares | Nil |
| Plus Non-Share Consideration | $150,000 |
| Proceeds Of Redemption - ITA 84(5)(d) | $150,000 |
| PUC Of Shares Given Up | ( 75,000) |
| ITA 84(3) Deemed Dividend | $ 75,000 |

| | |
|---|---|
| Adjusted Cost Base Of Preferred Shares | Nil |
| Plus Non-Share Consideration | $150,000 |
| Proceeds Of Disposition - ITA 86(1)(c) | $150,000 |
| Less ITA 84(3) Deemed Dividend | ( 75,000) |
| Adjusted Proceeds Of Disposition | $ 75,000 |
| Adjusted Cost Base Of Shares Given Up | ( 50,000) |
| Capital Gain | $ 25,000 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain | $ 12,500 |

### Economic Analysis

17-26. The shares held by David's daughter, Veronica, will have an adjusted cost base and a PUC of $1,000 and this will also be their initial fair market value. However, if the corporation prospers, all future increases in its value will accrue to her. In other words, by exchanging his common shares for non-growth preferred shares, Mr. Jones has frozen the value of his interest in Jones Inc.

17-27. In reviewing this example, you should note that Mr. Jones' potential gain has not disappeared. If he had simply sold his shares without the reorganization, he would have realized a gain of $450,000 ($500,000 - $50,000). As a result of the reorganization, he has recognized $100,000 ($75,000 dividend + $25,000 capital gain). This gain reflects the excess of the $150,000 non-share consideration received by Mr. Jones, over the $50,000 adjusted cost base of the original shares.

17-28. This reorganization has left an unrecognized gain of $350,000 ($500,000 - $150,000). This gain will remain unrecognized until such time as Mr. Jones' holding of preferred shares is either redeemed or sold for its fair market value of $350,000. As these shares have a PUC of nil, a subsequent redemption would result in an ITA 84(3) deemed dividend of $350,000. As the adjusted cost base of the shares is also nil, a subsequent sale of the shares would result in a capital gain of $350,000, the taxable amount of which would be one-half, or $175,000.

17-29. A final point here is that this example does not represent a typical ITA 86(1) estate freeze. While it does accomplish the goal of transferring future growth in the corporation to a related party, the approach used has resulted in current Tax Payable for Mr. Jones. This could have been avoided by limiting the non-share consideration to $50,000, the lesser of the $75,000 PUC and the $50,000 adjusted cost base of the old shares. It is this approach that would be used in a typical ITA 86(1) transaction.

### Exercise Seventeen - 2

**Subject:** Exchange Of Shares In Reorganization (ACB = PUC = Boot)

Mr. Sam Samson is the sole shareholder of Samdoo Ltd. It is a Canadian controlled private corporation and its common shares have a fair market value of $2,300,000, an adjusted cost base (ACB) of $1,000,000, and a paid up capital (PUC) of $1,000,000. At this time, Samdoo Ltd. has no balance in its GRIP account. Mr. Samson exchanges all of his Samdoo Ltd. shares for cash of $1,000,000 and preferred shares that are redeemable for $1,300,000. Determine the ACB and the PUC of the redeemable preferred shares. Indicate the amount, and type, of any income that will result from this transaction.

**SOLUTION available in print and online Study Guide.**

## Exercise Seventeen - 3

**Subject:** Exchange Of Shares In Reorganization (ACB > PUC, PUC = Boot)

Mr. Sam Samson is the sole shareholder of Samdoo Ltd. It is a Canadian controlled private corporation and its common shares have a fair market value of $2,300,000, an adjusted cost base (ACB) of $1,250,000, and a paid up capital (PUC) of $1,000,000. At this time, Samdoo Ltd. has no balance in its GRIP account. Mr. Samson exchanges all of his Samdoo Ltd. shares for cash of $1,000,000 and preferred shares that are redeemable for $1,300,000. Determine the ACB and the PUC of the redeemable preferred shares. Indicate the amount, and type, of any income that will result from this transaction.

## Exercise Seventeen - 4

**Subject:** Exchange Of Shares In Reorganization (ACB > Boot > PUC)

Mr. Sam Samson is the sole shareholder of Samdoo Ltd. It is a Canadian controlled private corporation and its common shares have a fair market value of $2,300,000, an adjusted cost base (ACB) of $1,250,000, and a paid up capital (PUC) of $1,000,000. At this time, Samdoo Ltd. has no balance in its GRIP account. Mr. Samson exchanges all of his Samdoo Ltd. shares for cash of $1,200,000 and preferred shares that are redeemable for $1,100,000. Determine the ACB and the PUC of the redeemable preferred shares. Indicate the amount, and type, of any income that will result from this transaction.

**SOLUTIONS available in print and online Study Guide.**

**We suggest your work Self Study Problem Seventeen-3 at this point.**

## Gift To Related Person - ITA 86(2)

### Background

17-30. ITA 86(2) contains a rule designed to prevent a taxpayer from using the reorganization of capital rollover provision to confer a benefit on a related person. This rule is applicable whenever the fair market value of the old shares exceeds the sum of the fair market value of the new shares and the fair market value of the non-share consideration received, and it is reasonable to regard all, or part, of this excess as a gift to a related person. You might wish to note that this provision is similar to the provision that is applicable when the use of an ITA 85(1) rollover involves a gift to a related person (see Chapter 16).

17-31. In situations where ITA 86(2) applies, the rules for the reorganization of share capital are as follows:

**Proceeds Of Disposition** Under ITA 86(2)(c), the proceeds of the disposition for capital gains purposes on the old shares will be equal to the lesser of:

- the non-share consideration, ***plus the gift***; and
- the fair market value of the old shares.

This compares to the proceeds of disposition under ITA 86(1)(c), which is equal to the cost of the new shares, plus any non-share consideration.

**Capital Losses** Under ITA 86(2)(d), any capital loss resulting from the disposition of the old shares will be deemed to be nil.

**Cost Of New Shares** Under ITA 86(2)(e), the cost to the taxpayer of the new shares will be equal to:

- the cost of the old shares; less
- the sum of the non-share consideration, ***plus the gift***.

This compares to a cost for the new shares under ITA 86(1)(b) equal to the cost of the old shares, less any non-share consideration.

17-32. To illustrate these procedures, we will modify the example in Paragraph 17-23 by decreasing the amount of consideration received to create a $100,000 gift. The revised example is as follows:

**EXAMPLE** Mr. David Jones owns all of the outstanding shares of Jones Inc. These common shares have an adjusted cost base of $50,000 and a paid up capital of $75,000. Because of the successful operations of the Company, the current fair market value of these common shares is $500,000.

Mr. Jones would like to have future growth in the value of the corporation accrue to his daughter, Ms. Veronica Jones. Veronica is 30 years old and has been actively and substantially involved in the business for over 5 years. To accomplish this, Mr. Jones exchanges his common shares for a $150,000 note payable from the corporation and preferred shares with a fair market value and a legal stated capital of $250,000. Common shares are purchased by Veronica Jones for $1,000. These are the only Jones Inc. common shares outstanding subsequent to these transactions.

## Calculation Of Gift

17-33. The gift involved in this approach is calculated as follows:

| | | |
|---|---|---|
| Fair Market Value Of Shares Given Up | | $500,000 |
| Less Fair Market Value Of Consideration: | | |
| Non-Share Consideration | ($150,000) | |
| Fair Market Value Of Preferred Shares | ( 250,000) | ( 400,000) |
| Gift | | $100,000 |

17-34. As his daughter is the only holder of common shares, this $100,000 gift would accrue to her. As she is clearly a related person, ITA 86(2) would be applicable.

## PUC Reduction

17-35. The PUC reduction and PUC of the preferred shares is calculated as follows:

| | | |
|---|---|---|
| Cost Of Non-Share Consideration (Note Payable) | | $150,000 |
| | | |
| Legal Stated Capital Of Preferred Shares | | $250,000 |
| Less The Excess, If Any, Of: | | |
| PUC Of Shares Given Up | ($ 75,000) | |
| Over The Non-Share Consideration | 150,000 | Nil |
| ITA 86(2.1)(a) PUC Reduction | | $250,000 |
| | | |
| Legal Stated Capital Of Preferred Shares | | $250,000 |
| ITA 86(2.1)(a) PUC Reduction | | ( 250,000) |
| PUC Of Preferred Shares | | Nil |

### Other Calculations

17-36. The remaining calculations that would be required under ITA 86(2) are as follows:

| | | |
|---|---|---|
| Adjusted Cost Base Of Common Shares Given Up | | $ 50,000 |
| Less: | | |
| Non-Share Consideration | ($150,000) | |
| Gift (See Paragraph 17-33) | ( 100,000) | ( 250,000) |
| Adjusted Cost Base Of Preferred Shares | | Nil |

| | |
|---|---|
| PUC Of Preferred Shares | Nil |
| Plus Non-Share Consideration | $150,000 |
| Proceeds Of Redemption - ITA 84(5)(d) | $150,000 |
| PUC Of Common Shares Given Up | ( 75,000) |
| ITA 84(3) Deemed Dividend | $ 75,000 |

| | |
|---|---|
| Proceeds Of Disposition Under ITA 86(2)(c) - Lesser Of: | |
| • Fair Market Value Of Shares Given Up = $500,000 | |
| • Non-Share Consideration Plus Gift ($150,000 + $100,000) = $250,000 | $250,000 |
| Less ITA 84(3) Deemed Dividend | ( 75,000) |
| Adjusted Proceeds Of Disposition - ITA 54 | $175,000 |
| Adjusted Cost Base Of Common Shares Given Up | ( 50,000) |
| Capital Gain | $125,000 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain | $ 62,500 |

17-37. At the time of the reorganization, the potential gain on David's shares was $450,000 ($500,000 - $50,000). In the original version of this example (Paragraph 17-25), a gain of $100,000 was recognized ($75,000 + $25,000) at the time of the reorganization, leaving $350,000 of the gain deferred until David's preferred shares are redeemed or sold (the shares had a fair market value of $350,000, with both their PUC and adjusted cost base equal to nil).

17-38. In this version of the example, the gain that is recognized at the time of the reorganization is $200,000 ($75,000 + $125,000), $100,000 larger than in the original version of the example. This reflects the fact that the amount of the gift was added to the ITA 86(2)(c) proceeds of disposition, resulting in a capital gain that is $100,000 larger. It is important to note, however, the total gain, current and deferred, is unchanged at $450,000. While the current gain is increased to $200,000, the deferred amount is reduced to $250,000 (the preferred shares have a fair market value of $250,000, with both their PUC and adjusted cost base equal to nil). While the gift resulted in current taxation which could have been deferred, it did not involve a penalty in the form of additional taxation.

17-39. ITA 86(2) does, however, involve a penalty to his daughter Veronica. The new common shares issued to Veronica will have a fair market value equal to $101,000, the $1,000 she paid plus the $100,000 gift. The $100,000 additional value will not be reflected in the adjusted cost base of her shares and, as a consequence, this amount will be taxed when she disposes of the shares.

17-40. In effect, the granting of the benefit has increased the amount that will be subject to taxation in the hands of Veronica by the $100,000 amount of the gift, without reducing Mr. Jones' total current and deferred income on the shares. This makes it clear that ITA 86 reorganizations should be structured in a manner that avoids such benefits being granted.

**Exercise Seventeen - 5**

**Subject:** Gift To A Related Party - ITA 86(2)

Janrev Inc. is a Canadian controlled private corporation. Its shares have a fair market value of $1,600,000 and a paid up capital (PUC) of $250,000. Ms. Jan Reviser owns 80 percent of the shares. Her shares have an adjusted cost base of $200,000. The remaining 20 percent of the shares are held by her 19 year old daughter and they have an adjusted cost base of $50,000. On May 1, 2019, Ms. Reviser exchanges all of her Janrev Inc. shares for cash of $300,000 and preferred shares that are redeemable for $800,000. At this time, Janrev has no balance in its GRIP account. Indicate the amount, and type, of any income that will result from this transaction.

**SOLUTION available in print and online Study Guide.**

## Using ITA 86(1) - Tax Planning Considerations

### *General Usage*

17-41. The major advantages of using ITA 86(1), as compared to using ITA 85(1), can be described as follows:

- An ITA 86(1) share reorganization may be simpler to implement than a Section 85 roll-over as it does not require the use of a second corporation.
- The corporate law steps are easier, only requiring shares to be exchanged, and possibly new share classes to be formed.
- The use of ITA 86(1) does not require an election to be filed with the CRA.

17-42. The disadvantages associated with using ITA 86(1) are as follows:

- When only a single corporation is used, it is difficult to segregate investment income from active business income.
- A single corporation exposes all of the assets to any operating risk, and limited liability protection is reduced.
- In an ITA 86(1) reorganization, all of the taxpayer's shares of a particular class have to be exchanged. This can be a problem if the original shareholder wishes to retain some of the common or growth shares.
- ITA 86 does not provide the range of elected values that is available Under ITA 85(1).

17-43. It is usually possible to get around the last disadvantage by re-issuing common shares to the original shareholder after the reorganization is completed.

### *Use In Key Employee Successions*

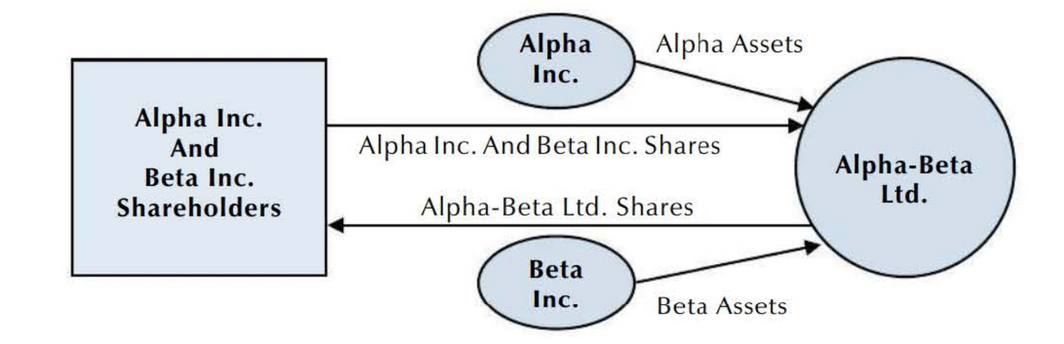
17-44. In addition to its use in estate freezes, an exchange of shares can be very effective when arranging for gradual succession to a key employee. For example, consider a situation where an employee has little personal equity, but has a good work record with the company and excellent owner-manager potential.

17-45. An ITA 86(1) reorganization could be used to convert common shares owned by the existing shareholder into preferred shares. The employee could then purchase the common shares over some agreed upon succession period. The annual investments in common shares would likely be modest, as most of the company's value would be reflected in the preferred shares, making the investments feasible for the incoming shareholder. The original owner could continue to be involved in the business throughout the succession years.

17-46. Eventually, when the original owner is ready to sell the common shares, the incoming shareholder will have the benefit of several years of management experience, and should be able to obtain funding to acquire the preferred shares from the original owner.

**We suggest you work Self Study Problems Seventeen-4 and 5 at this point.**

**Figure 17 - 3**
**ITA 87 Amalgamation Example**




# Amalgamations - ITA 87

## The Nature Of An Amalgamation

17-47. ITA 87 provides for a tax deferred rollover in situations where there is an amalgamation of corporations. This may involve two independent corporations wishing to merge and continue their business affairs on a combined basis. Alternatively, associated or related corporations may amalgamate to pursue common corporate goals.

17-48. If the two corporations want to transfer their assets to a new corporation on a tax free basis, the rollover provisions of ITA 87 would apply. The following simple example will illustrate this kind of situation (illustrated in Figure 17-3):

> **EXAMPLE** The shareholders of Alpha Inc. have shares with an adjusted cost base of $1,000,000 and a fair market value of $5,000,000, while the shareholders of Beta Inc. have shares with an adjusted cost base of $1,700,000 and a fair market value of $5,000,000. All of the assets and liabilities (except intercompany balances) of Alpha Inc. and Beta Inc. are transferred to a new Company, Alpha-Beta Ltd. The shareholders of Alpha Inc. and Beta Inc. exchange their shares for shares in Alpha-Beta Ltd.

17-49. In the absence of a rollover provision, the exchange of shares would be viewed as a disposition of the Alpha Inc. shares and the Beta Inc. shares, combined with an acquisition of the Alpha-Beta Ltd. shares. The fact that the share dispositions could result in taxable capital gains and the asset transfers could result in taxable capital gains and recapture, could serve to discourage the combination of the two companies.

17-50. Fortunately, ITA 87 contains rollover provisions for both the transfer of assets to the amalgamated corporation and for the exchange of shares. The conditions necessary for this rollover to apply are as follows:

- All of the predecessor corporations must be taxable Canadian corporations.
- All shareholders of the predecessor corporations must receive shares of the amalgamated corporation due to the amalgamation.
- All of the assets and liabilities of the predecessor corporations, other than intercompany balances, must be transferred to the amalgamated corporation in the amalgamation.
- A formal amalgamation procedure, supported by the relevant corporate legislation is required. The transfer cannot simply be a normal purchase of property, or involve the distribution of assets on the winding-up of a corporation.

## Position Of The Amalgamated Company

17-51. The tax values for the amalgamated corporation's assets will simply be the sum of the tax values of the assets that were present in the records of the predecessor corporations. In addition, all types of loss carry forwards (capital, non-capital, and farm) of the predecessor corporations flow through and become available to the amalgamated corporation.

17-52. The predecessor corporations will be deemed to have a taxation year that ends immediately before the amalgamation and, in most situations, this will result in an extra taxation year that will count towards the expiration of losses with a limited carry forward period. The amalgamated corporation is deemed to have been formed on the date of the amalgamation and may choose any year end it wishes. We would also note that, while this may not be consistent with corporate law, the *Income Tax Act* treats the amalgamated company as a brand new company and the predecessor companies as if they have come to an end.

17-53. With respect to assets, reserves, loss carry forwards, and other tax accounts of the predecessor companies, ITA 87 provides rollover provisions as follows:

**Rollover Provisions In ITA 87 Amalgamations**

| Item | Rollover Effect |
|---|---|
| Inventories | At Cost |
| Depreciable Capital Property | At UCC |
| Non-Depreciable Capital Property | At ACB |
| Reserves | Flowed Through |
| Non-Capital Losses | Flowed Through |
| Net Capital Losses | Flowed Through |
| Restricted Farm Losses | Flowed Through |
| General Rate Income Pool (GRIP) (See Note 1) | Flowed Through |
| Low Rate Income Pool (LRIP) (See Note 2) | Flowed Through |
| Capital Dividend Account (See Note 3) | Flowed Through |
| Refundable Dividend Tax On Hand (See Note 3) | Flowed Through |

**Note 1** If a CCPC is formed as the result of an amalgamation, ITA 89(5) may be applicable. In situations where a predecessor corporation was a CCPC, this subsection provides for the flow through of its GRIP account to the amalgamated company. Where the predecessor was a non-CCPC, a notional GRIP is calculated and flows through to the amalgamated company.

**Note 2** If a non-CCPC is formed as the result of an amalgamation, ITA 89(9) may be applicable. In situations where a predecessor corporation was a non-CCPC, this subsection provides for the flow through of its LRIP account to the amalgamated company. Where the predecessor was a CCPC, a notional LRIP is calculated and flowed through.

**Note 3** The amalgamated company is treated as a public company if, prior to the amalgamation, any of the predecessor companies was a public company. If this is the case, the amalgamated company will no longer have access to any capital dividend accounts, or refundable dividend tax on hand accounts of the predecessor companies.

17-54. As can be seen in the preceding table, ITA 87 basically provides for a summing of the relevant tax values of the assets of the two companies that are amalgamating. The amalgamated corporation will be liable for taxes on future recapture and capital gains on the same basis as the predecessor corporations.

17-55. With respect to loss carry forwards, the limitations that were discussed in Chapter 14 are applicable if there is an acquisition of control. As noted, the deemed year end of the predecessor corporations will count as one year in any carry forward period. However, losses carried forward may qualify for deduction in the first taxation year of the amalgamated company.

## Position Of The Shareholders

17-56. The shareholders of the predecessor corporations are deemed to dispose of their shares for proceeds equal to the adjusted cost base of the shares, and they are deemed to acquire the shares of the amalgamated company at the same value. For these general provisions to apply, ITA 87(4) specifies the following conditions:

- The shareholders must not receive any consideration other than shares in the amalgamated company.
- The original shares must be capital property of the shareholders.
- The amalgamation must not result in a deemed gift to a person related to the shareholders.

## Vertical Amalgamations

17-57. In situations where there is a desire to combine a parent and its subsidiary, a choice of rollovers may be available. The alternative to ITA 87, "Amalgamations", is the use of ITA 88(1), "Winding-Up". However, ITA 88(1) is only applicable to situations where the parent company owns 90 percent or more of the shares of each class of capital stock of a subsidiary. In contrast, ITA 87 can be used without regard to the percentage of ownership.

## Asset Bump-Ups

17-58. You may recall from an advanced financial accounting course that the cost of acquiring a subsidiary will usually exceed both the carrying values and the sum of the fair values of the acquired identifiable assets.

> **EXAMPLE** Placor Inc. acquires 100 percent of the outstanding voting shares of Lacee Ltd. at a cost of $1,000,000. At this time the net identifiable assets of Lacee had carrying values of $700,000 and tax values of $650,000. The fair value of these assets totaled $900,000.

17-59. The excess of the $1,000,000 investment cost over the tax values total of $650,000 creates a problem when there is an amalgamation involving either ITA 87 or ITA 88(1). Both of these provisions transfer assets to the amalgamated company at tax values. In the absence of a special legislative provision, the $350,000 excess of the investment cost over tax values of the assets will be lost.

17-60. Fortunately, there is a provision that provides a limited amount of relief from this adverse tax consequence. As will be discussed in our coverage of winding-up (Paragraph 17-82), ITA 88(1) provides for a "bump-up" in certain asset values to reflect the parent company's excess of its investment cost over the subsidiary's tax values.

17-61. ITA 87 provides for the same bump-up under ITA 87(11) by referring to the ITA 88(1) provision. However, there is a difference. Under ITA 88(1), the bump-up is available in situations where the parent owns 90 percent or more of the issued shares. Under ITA 87(11), the bump-up is only available when the parent owns 100 percent of the subsidiary's issued shares. Note that no bump-up is available under either provision when the ownership percentage is less than 90 percent.

## Non-Tax Considerations

17-62. While a statutory amalgamation does not involve a new company, there are likely to be significant legal complications. Each of the predecessor companies will have contracts with employees, suppliers, and customers. While they are still legally in force, modifications may be required to make the terms more compatible throughout the organization. There may also be problems with creditors. In fact, it is not uncommon for debt covenants to have a provision requiring the approval of debt holders before an amalgamation can take place. These factors may add considerable complexity to the amalgamation process.

## Amalgamations - Tax Planning Considerations

17-63. A Section 87 amalgamation offers a number of opportunities for tax planning. Some of the possibilities include:

- The utilization of loss carry forward amounts that the predecessor corporation(s) might not be able to absorb. Note, however, that if there is an acquisition of control, the usual restrictions on the use of loss carry forwards apply.
- With respect to acquisitions of control in the amalgamation process, we would note that, if the two predecessor corporations are related, an amalgamation will not result in an acquisition of control. However, if they are not related and the shareholders of one of the predecessor companies owns the majority of the voting shares in the amalgamated company, that company will be considered to have acquired control of the other predecessor company prior to the amalgamation.
- Current year losses of one predecessor corporation can effectively be utilized against Taxable Income of the other. Note, however, that corporate law in Canada does not generally allow a corporation to amalgamate if its financial health is in question. For example, a company that is insolvent is not allowed to amalgamate with another company.
- Bringing together a profitable and an unprofitable corporation may allow for a faster write-off of capital assets (through CCA) than would otherwise be possible by the unprofitable predecessor corporation.
- The amalgamation may provide for an increase in the amount of the manufacturing and processing profits tax deduction.

17-64. The timing of an amalgamation can be an important tax planning issue. As the amalgamation transaction results in a deemed year end, the company may have a short fiscal year for purposes of calculating CCA. In addition, outstanding reserves may have to be brought into income sooner, and the short fiscal period will count as a full year in the eligible loss carry forward years.

17-65. For income tax instalments there is a look through provision. While the amalgamated company does not have a previous tax year on which to base instalment payments of income tax, prepayments continue to be required based on the instalment history of the predecessor corporations.

### Exercise Seventeen - 6

**Subject: ITA 87 Amalgamations**

During its taxation year ending December 31, 2018, Downer Ltd. incurs a non-capital loss of $93,000 and a net capital loss of $150,000. Neither loss can be carried back. On January 1, 2019, using the provisions of ITA 87, the Company is amalgamated with Upton Inc., an unrelated company that also has a December 31 year end. The combined company is named Amalgo Inc. and it elects to use a December 31 year end. The terms of the amalgamation give 20,000 Amalgo Inc. shares to the Downer Ltd. shareholders and 150,000 Amalgo Inc. shares to the Upton Inc. shareholders. Amalgo Inc. was established with only one class of shares. This means that all of the newly issued shares are identical. During the year ending December 31, 2019, Amalgo Inc. has Net Income For Tax Purposes of $1,200,000, including over $300,000 in taxable capital gains. During its 2019 taxation year, will Amalgo Inc. be able to deduct the losses incurred by Downer Ltd. prior to the amalgamation? Explain your conclusion.

**SOLUTION available in print and online Study Guide.**

# Winding-Up Of A 90 Percent Owned Subsidiary

## The Nature Of A Winding-Up

### *Winding-Up Of Corporations In General*

17-66. IT-126R2 states that a corporation is considered to have been "wound up" where:

(a) it has followed the procedures for winding-up and dissolution provided by the appropriate federal or provincial companies *Act* or winding-up *Act*, or

(b) it has carried out a winding-up, other than by means of the statutory procedures contemplated in (a) above, and has been dissolved under the provisions of its incorporating statute.

17-67. In general, a winding-up operation requires that all outstanding creditor claims be satisfied and that all corporate property be distributed to the shareholders before the winding-up is undertaken. IT-126R2 also notes that, where there is substantial evidence that dissolution procedures will be completed within a short period of time, Section 88(1) can be used prior to the completion of the wind-up. Note, however, that losses cannot be accessed until the actual wind-up takes place.

17-68. A winding-up may be undertaken for several reasons. As with amalgamations, a winding-up allows for the losses of a subsidiary to be carried over to the parent corporation. Winding-ups are also undertaken to simplify an organizational structure, or when a subsidiary is ceasing its business operations.

### *90 Percent Owned Subsidiary*

17-69. The two major Subsections of ITA 88 can be described as follows:

**ITA 88(1)** This Subsection is a rollover provision, providing for the tax free combination of the assets of a 90 percent or more owned subsidiary with those of its parent.

**ITA 88(2)** This Subsection deals with the general winding-up of corporations, other than those to which ITA 88(1) is applicable. It is not a rollover provision.

17-70. At this point we are concerned only with the provisions contained in ITA 88(1). The content of ITA 88(2) will be considered beginning in Paragraph 17-94.

17-71. To use the ITA 88(1) rollover, the parent corporation must own at least 90 percent of each class of the subsidiary's shares. Therefore, not all winding-ups of subsidiaries qualify for the treatment described in ITA 88(1). A winding-up involving a subsidiary where a parent corporation has control, but owns less than 90 percent of the issued shares, would be implemented under the provisions of ITA 88(2). This provision would not allow for a tax free transfer of assets.

17-72. If the parent has the required 90 percent or more ownership, it is permitted to exchange the subsidiary's shares for the assets of the subsidiary on a tax deferred basis. This transaction is very similar to an amalgamation, as it allows the assets of the two companies to be combined without recognizing any accrued capital gains or recaptured CCA on the transfers required to effect the combination. Note that this rollover provision only applies to ITA 88(1) transactions. It does not apply when an ITA 88(2) wind-up takes place.

17-73. As with other rollovers, there are two components to a winding-up transaction. The first is the acquisition of the subsidiary's assets by the parent and the second is the deemed disposition of the subsidiary's shares by the parent. We will now turn our attention to these components.

## Acquisition Of Assets

### General Rules

17-74. In an ITA 88(1) winding-up, the subsidiary is deemed to have disposed of its assets and the parent is deemed to have acquired the assets on the following basis:

- A cost of nil in the case of Canadian or foreign resource property.
- The "cost amount" to the subsidiary in the case of other property. Cost amount is defined in ITA 248(1) as UCC for depreciable property and adjusted cost base for non-depreciable capital property.

### GRIP Balances

17-75. ITA 89(6) applies to situations in which a CCPC has wound up a subsidiary under ITA 88(1). If the subsidiary was also a CCPC, this provision provides for a flow through of the subsidiary's GRIP balance to the GRIP balance of the parent company.

17-76. A second, much more complex provision in ITA 89(6), applies when the subsidiary is a non-CCPC. This provision attempts to measure what the subsidiary's GRIP would have been at the end of its last taxation year had it been a CCPC at that time. This amount will also be included in the parent company's GRIP.

### LRIP Balances

17-77. ITA 89(10) applies when a non-CCPC has wound up a subsidiary under ITA 88(1). If the subsidiary was also a non-CCPC, this provision provides for a flow through of the subsidiary's LRIP balance to the LRIP balance of the parent company.

17-78. Once again, a second and much more complex provision applies when the subsidiary is a CCPC. This provision attempts to measure what the subsidiary's LRIP would have been at the end of its last taxation year had it been a non-CCPC at that time. This amount will also be transferred to the parent company's LRIP.

### Deferral Of Loss Carry Forwards

17-79. As indicated previously, an ITA 88(1) winding up is very similar to an amalgamation. There is, however, one important difference between an amalgamation under ITA 87 and the winding-up of a subsidiary under ITA 88(1) and this involves loss carry forwards.

17-80. As is generally the case under ITA 87, non-capital losses and net capital losses of the subsidiary will be available to the parent company when ITA 88(1) is used. However, under ITA 88(1.1), they will not become available until the first taxation year of the parent that begins after the date that the winding-up period commences.

> **EXAMPLE** If a parent's fiscal year begins on February 1 and the winding-up commences on February 15, 2019, the losses of the subsidiary will not be available to the parent until its fiscal year beginning February 1, 2020.

17-81. In those situations where the subsidiary has a different year end than the parent, subsidiary losses are deemed to have occurred in the parent's fiscal year that includes the subsidiary's year end.

> **EXAMPLE** A parent has a June 30 year end, while its subsidiary has a September 30 year end. A winding-up commences on August 15, 2019 and is completed by August 31, 2019. The subsidiary has a non-capital loss for the period that is terminated on August 31, 2019 by the winding-up.
>
> **ANALYSIS** The loss will be deemed to have occurred in the parent's year ending June 30, 2020. This would suggest that the loss would not expire until the parent's year ending June 30, 2040. However, ITA 88(1.1)(b) limits the carry forward period to the period that would have been available to the subsidiary if it had not been wound up. This means that, in actual fact, the loss expires on June 30, 2039. The losses of the subsidiary are not available to the parent until its fiscal year beginning on July 1, 2020.

## Exercise Seventeen - 7

**Subject:** Losses In A Winding-Up

Park Inc. has a September 15 year end, while its 100 percent owned subsidiary, Side Ltd., has an October 31 year end. There is a winding-up of Side Ltd., using the roll-over provision found in ITA 88(1), on June 30, 2019. Side Ltd. has a non-capital loss of $50,000 for the period November 1, 2018 to June 30, 2019. What is the earliest taxation year in which the $50,000 loss can be deducted? If it is not deducted then, in what taxation year will it expire?

**SOLUTION available in print and online Study Guide.**

### Asset Bump-Up

17-82. As we pointed out in our discussion of amalgamations, ITA 88(1) provides for a transfer of all or part of the excess of the purchase price of a 90 percent or more owned subsidiary's shares over the tax values of the subsidiary's assets. As noted, this bump-up is also available under ITA 87 when the parent owns 100 percent of the subsidiary. Under either of these provisions, the amount of this bump-up in tax values is limited by two amounts:

1. The basic amount of the bump-up is found in ITA 88(1)(d)(i) and (i.1). This amount is the excess of the adjusted cost base of the subsidiary shares held by the parent, over the sum of:
   - the tax values of the subsidiary's net assets at the time of the winding-up; and
   - dividends paid by the subsidiary to the parent since the time of the acquisition (including capital dividends).
2. ITA 88(1)(d)(ii) further limits the amount that can be recognized to the excess of the fair market value of the subsidiary's non-depreciable capital property over their tax values at the time the parent acquired control of the subsidiary.

17-83. The following example will illustrate these procedures:

**EXAMPLE** On December 31, 2009, ParentCo acquires 100 percent of the outstanding shares of SubCo for $5,000,000. At that time, the only non-depreciable capital property owned by SubCo was land with a fair market value of $2,000,000 and a cost of $1,000,000. Between December 31, 2009 and December 31, 2019, SubCo pays dividends of $150,000 to ParentCo. On December 31, 2019, when the tax values of SubCo's assets total $4,200,000, SubCo is absorbed in a Section 88(1) winding-up.

**ANALYSIS** The amount of the available asset bump-up will be the lesser of the two amounts described in Paragraph 17-82:

| | | |
|---|---|---|
| Adjusted Cost Base Of SubCo Shares | | $5,000,000 |
| Tax Values Of SubCo Assets At Winding-Up | ($4,200,000) | |
| Dividends Paid By SubCo Since Its Acquisition | ( 150,000) | ( 4,350,000) |
| Excess | | $ 650,000 |

| | |
|---|---|
| Fair Market Value Of Land At Acquisition | $2,000,000 |
| Cost Of Land At Acquisition | ( 1,000,000) |
| Excess | $1,000,000 |

17-84. In this situation, the write-up of the land is restricted to the lower figure of $650,000. As a result, the subsidiary is deemed to have disposed of the land for $1,000,000 with no gain or loss. However, the parent is deemed to have acquired the same land for $1,650,000.

## Exercise Seventeen - 8

**Subject:** Winding-Up Of A 90 Percent Or More Owned Subsidiary

On January 1, 2015, Procul Ltd. acquired 100 percent of the outstanding shares of Lorne Inc. at a cost of $1,200,000. At this point in time, the fair market value of Lorne's identifiable net assets was $850,000, including $270,000 for the Land. The tax values of the net assets at that time totalled $410,000.

On December 31, 2019, there is a winding-up of Lorne Inc. under the provisions of ITA 88(1). Lorne Inc. has paid no dividends since its acquisition by Procul Ltd. On December 31, 2019, the condensed Balance Sheet of Lorne Inc. is as follows:

| | |
|---|---:|
| Cash | $120,000 |
| Land - At Cost (Purchased In 2011) | 140,000 |
| Depreciable Assets - At UCC (Purchased In 2011) | 240,000 |
| Total Assets | $500,000 |
| | |
| Liabilities | $ 75,000 |
| Shareholders' Equity | 425,000 |
| Total Equities | $500,000 |

Determine the tax values that will be recorded for Lorne Inc.'s assets after they have been incorporated into the records of Procul Ltd.

**SOLUTION available in print and online Study Guide.**

## Disposition Of Shares

17-85. The disposition of shares component of the winding-up is straightforward. In general, the parent is deemed to have disposed of its shares of the subsidiary for proceeds equal to the adjusted cost base of the shares. As an example, assume the parent had paid $4,000,000 for the subsidiary's shares. This amount would also be the deemed proceeds of the disposition and there would be no capital gain.

17-86. An exception to this general rule will arise if the tax values of the subsidiary's net assets transferred and the paid up capital of the subsidiary's shares is more than the amount paid for the shares by the parent. In this case, the deemed proceeds of disposition will be the lesser of the paid up capital and the tax values of the net assets transferred. As a result, a capital gain can arise in these situations.

**EXAMPLE** Prawn Ltd. owns 100 percent of the outstanding shares of Shrimp Inc. The cost of these shares was $4,000,000. This subsidiary is being wound up under the provisions of ITA 88(1). At the time of the winding-up, the tax values of the subsidiary's net assets total $4,800,000 and the PUC of the subsidiary's shares is $4,500,000.

**ANALYSIS** Given these facts, the exception applies and the deemed proceeds of disposition would be the greater of the $4,000,000 cost of the shares and $4,500,000. This latter figure is the lesser of the $4,800,000 tax value of the subsidiary's net assets and the $4,500,000 PUC of the subsidiary's shares. This gives proceeds of disposition of $4,500,000 and a capital gain of $500,000 ($4,500,000 - $4,000,000). It is expected that such gains situations would be fairly rare and, because the proceeds are defined using cost except when it is less than the alternative values, there is no possibility of a capital loss.

**Figure 17 - 4**
**Comparison Of Amalgamation Under ITA 87 And Winding-Up Under ITA 88(1)**

| Factor | Amalgamation - ITA 87 | Winding-Up Of 90% Owned Subsidiary - ITA 88(1) |
|---|---|---|
| Valuation of assets | Tax values of assets of predecessor corporations carried forward to amalgamated company. | Tax values of subsidiary's assets carried forward to parent. |
| Recognition of some of the excess of investment cost over tax values | Recognition only if 100% owned subsidiary. If 100% owned, same treatment as ITA 88(1). | Write-up allowed if excess is associated with values of non-depreciable capital property. |
| Capital cost allowances | Claim in last year of predecessor and first year of amalgamated corporation. | No claim by subsidiary in year of winding-up, but available to parent in year of winding-up. |
| Loss carry forwards | Carried forward. However, their use may be limited if the amalgamation results in an acquisition of control. | Carried forward, but only available to parent beginning in taxation year after winding-up. |
| Year end | Deemed year end before amalgamation, counts one year for loss carry forwards. | Year end of parent corporation continued. Subsidiary has a terminal year end that counts as one taxation year. |

## Tax Planning Considerations - Amalgamation Vs. Winding-Up

17-87. Figure 17-4 contains a comparison of the features of an amalgamation under ITA 87 and the winding-up of a subsidiary that is at least 90 percent owned under ITA 88(1). A discussion of several of the items follows.

17-88. A significant consideration in deciding between an amalgamation under ITA 87 and a winding-up under ITA 88(1) is the ability to recognize all or part of the excess of investment cost over tax values. In the case of an ITA 87 amalgamation, recognition is possible only in cases involving a parent and a 100 percent owned subsidiary. Under ITA 88(1), recognition can occur as long as the parent owns 90 percent or more of each class of the subsidiary's issued shares.

17-89. Under either provision, it is possible that substantial tax values will disappear in the transaction. This would suggest that, when the adjusted cost base of the parent's investment is significantly greater than the tax values of the subsidiary's net assets, it may be better to continue to operate the subsidiary as a separate legal entity.

17-90. Under the amalgamation procedures, the predecessor corporations will have a deemed year end, which will count towards the expiry of time limited non-capital loss carry forwards. However, subject to the acquisition of control rules, the amalgamated company will be able to use the losses immediately.

17-91. In contrast, the parent company that is using ITA 88(1) to absorb a 90 percent owned subsidiary will have its usual year end. However, it will not be able to use subsidiary loss carry forwards until the first taxation year beginning subsequent to the winding-up. In addition, the wind-up will count as an additional year in the expiry of time limited loss carry forwards. The analysis of this situation may be complicated by differing year ends for the two corporations.

17-92. In considering CCA claims, ITA 87 creates a deemed year end for both predecessor corporations, requiring them to take pro rata CCA claims for what will normally be a short fiscal period. Under the ITA 88(1) procedures, the subsidiary disposes of its assets prior to its year end and, as a consequence, there will be no claim for CCA in the subsidiary's final year. However, CCA may be claimed on these assets by the parent company, subsequent to their being acquired under the winding-up procedures.

17-93. If the subsidiary is not 100 percent owned, ITA 88(1) cannot be used unless the minority shareholder group is at arm's length with the parent company. If the minority shareholders are at arm's length and ITA 88(1) can be used to transfer the assets belonging to the controlling interest, an application of this Subsection will generally have tax consequences for the non-controlling interest. A winding-up will require reporting of capital gains and recaptured CCA on property distributed by the subsidiary to the minority shareholders. Further, any liquidating dividend paid to the minority shareholders will be a taxable dividend.

**We suggest you work Self Study Problem Seventeen-6 at this point.**

# Winding-Up Of A Canadian Corporation

## The Nature Of The Transaction

### *Wind-Up (Liquidation) Vs. Rollover*

17-94. The winding-up procedures for a Canadian corporation, as described in ITA 88(2), are applicable where a corporation is being liquidated. If, for example, owners of a corporation decide that the business is no longer viable, winding-up procedures can be used in the disposition of the corporation's assets and the distribution of the resulting proceeds to the shareholders.

17-95. In distinguishing the winding-up of a 90 percent or more owned subsidiary from a liquidating winding-up, you should note that the liquidation of a business has quite different objectives. In the case of the winding-up of a 90 percent or more owned subsidiary, we are usually not disposing of the business but, rather, are transferring its assets to a different legal entity that is controlled by the same investor or group of investors that previously had indirect control of its operations. This explains why a rollover is available on the winding-up of a 90 percent or more owned subsidiary, and no equivalent provision is available for the winding-up when a liquidation is under way.

### *Distributions To Shareholders*

17-96. While a winding-up can be implemented by distributing corporate assets directly to the shareholders, it is generally simpler for the corporation to liquidate its assets, pay off its creditors, pay any taxes that are applicable at the corporate level, and distribute the after tax proceeds to the shareholders.

17-97. The distribution to shareholders becomes a fairly complex issue when a corporation is liquidated, as the proceeds available for distribution will consist of a combination of capital being returned, earnings that can be distributed on a tax free basis, and earnings that can only be distributed in the form of taxable dividends. A further complication is that there may be a combination of eligible and non-eligible dividends.

### *Disposition Of An Incorporated Business*

17-98. Later in this Chapter we will discuss the transfer of an incorporated business to a different group of owners. This can be accomplished through a sale of shares or, alternatively, through a sale of the corporation's assets. If the sale of assets is the more advantageous approach, the provisions of ITA 88(2) apply. That is, the sale of assets will be followed by a winding-up, with the after tax proceeds of the winding-up being distributed to the shareholders. While the business itself will continue to operate, the assets will now be on the books of a different legal entity.

# Example

## Basic Data

17-99. The ITA 88(2) procedures will be illustrated in the following example.

**EXAMPLE** The Marker Company, a Canadian controlled private corporation, has been in operation for 20 years. It has a December 31 year end. On January 1, 2019, the following Balance Sheet, based on tax values, has been prepared in contemplation of liquidating the Company:

**The Marker Company**
**Balance Sheet - As At January 1, 2019 (Tax Values)**

| | |
|---|---|
| Accounts Receivable (Net Realizable Value) | $ 12,000 |
| Refundable Dividend Tax On Hand | 8,000 |
| Land - At Cost (Note One) | 250,000 |
| Building - At UCC (Note Two) | 195,000 |
| Total Assets | $465,000 |
| Liabilities | Nil |
| Common Stock - No Par (Note Three) | $ 10,000 |
| Retained Earnings (Note Three) | 455,000 |
| Total Equities | $465,000 |

**Note One** The current fair market value of the Land is $300,000.

**Note Two** The cost of the Building was $320,000. Its current fair market value is $350,000.

**Note Three** The paid up capital and adjusted cost base of the common shares is $10,000. The Retained Earnings includes $75,000 in the capital dividend account. The Company's GRIP balance is nil.

The assets of the Company are sold for their fair market values which total $662,000 ($12,000 + $300,000 + $350,000). The Company has no other income for the taxation year. The provincial corporate tax rates are 2.5 percent on income eligible for the small business deduction and 14 percent on other corporate income. No reserves were deducted in 2018.

## Cash Available For Distribution

17-100. At the corporate level, the proceeds from the disposition of the individual assets and the related tax effects are as follows:

| Asset | Proceeds | Taxable Capital Gain | Active Business Income |
|---|---|---|---|
| Accounts Receivable | $ 12,000 | Nil | Nil |
| Land | 300,000 | $25,000 | Nil |
| Building | 350,000 | 15,000 | $125,000 |
| Totals | $662,000 | $40,000 | $125,000 |

The Tax Payable on Marker's Taxable Income of $165,000 ($40,000 + $125,000) would be calculated as follows:

| | |
|---|---|
| Federal Tax On Active Business Income [(38% - 10% - 19%)($125,000)] | $11,250 |
| Federal Tax On Investment Income [(38% - 10% + 10-2/3%)($40,000)] | 15,467 |
| Part I Tax Payable | $26,717 |
| Provincial Tax On Active Business Income [(2.5%)($125,000)] | 3,125 |
| Provincial Tax On Investment Income [(14%)($40,000)] | 5,600 |
| Total Corporate Tax Payable | $35,442 |

17-101. Under the transitional rules for segregating a corporation's January 1, 2019 RDTOH into eligible and non-eligible components, the amount to be allocated to the Eligible RDTOH account would be the lesser of:

- The January 1, 2019 balance in the single RDTOH account; and
- 38-1/3 percent of the January 1, 2019 GRIP balance.

17-102. As the January 1, 2019 GRIP balance is nil, none of the $8,000 RDTOH balance would be allocated to Eligible RDTOH. It would all go to Non-Eligible RDTOH.

17-103. The only 2019 addition to an RDTOH balance would be the refundable portion of Part I Tax Payable. This amount would be the least of:

| | |
|---|---|
| • 30-2/3% Of Investment Income [(30-2/3%)($40,000)] | $12,267 |
| • 30-2/3% Of Taxable Income, Less Amount Eligible For Small Business Deduction [(30-2/3%)($165,000 - $125,000)] | $12,267 |
| • Part I Tax Payable | $26,717 |

17-104. This amount would also be allocated to the Non-Eligible RDTOH, resulting in the following balance in that account:

| | |
|---|---|
| Transitional Allocation | $ 8,000 |
| Part I Refundable Tax | 12,267 |
| Non-Eligible RDTOH | $20,267 |

17-105. The after tax amount of cash that is available for distribution to shareholders is calculated as follows:

| | |
|---|---|
| Gross Proceeds | $662,000 |
| Corporate Tax Payable | ( 35,442) |
| Non-Eligible RDTOH* | 20,267 |
| Available For Distribution | $646,825 |

*Given the size of the gross proceeds, the balance in the Non-Eligible RDTOH is clearly going to be less than 38-1/3 percent of the dividends that will be declared.

### Distribution To Shareholders

17-106. The balance in the capital dividend account can be distributed to the shareholders as a tax free capital dividend. This balance is calculated as follows:

| | |
|---|---|
| Balance Before Dispositions (Balance Sheet Note Three) | $ 75,000 |
| Disposition Of Land | 25,000 |
| Disposition Of Building | 15,000 |
| Capital Dividend Account - Ending Balance | $115,000 |

17-107. Prior to the sale of assets, the Company's GRIP balance was nil. As all of the income resulting from the sale of assets was either investment income or eligible for the small business deduction, there would be no addition to the GRIP account resulting from the sale of assets. This means that all dividends paid that are subject to tax would be non-eligible. The non-eligible taxable dividend component of the total distribution to the shareholders is calculated as follows:

| | |
|---|---|
| Total Distribution | $646,825 |
| Paid Up Capital | ( 10,000) |
| ITA 84(2) Deemed Dividend On Winding-Up* | $636,825 |
| Capital Dividend Account (Balance In Account) | ( 115,000) |
| Non-Eligible Dividend Subject To Tax | $521,825 |

*As explained in Chapter 14, in a winding up, when the total distribution to shareholders exceeds the PUC of the shares being canceled, the excess is an ITA 84(2) deemed dividend. This deemed dividend is treated first as a capital dividend, if the appropriate election is filed. Any excess is treated as an eligible or non-eligible taxable dividend.

17-108. Treatment of the $115,000 as a capital dividend is conditional on the appropriate election being made under ITA 83(2). The remaining taxable non-eligible dividend will be grossed up to $600,099 [(115%)($521,825)]. The dividend will provide a federal dividend tax credit of $54,190 [(9/13)(15%)($521,825)].

17-109. In the ITA 54 definition of "proceeds of disposition", Paragraph j indicates that amounts that are deemed to be a dividend under ITA 84(2) are not included in this amount. As a consequence, in determining the capital gain resulting from the distribution to the shareholders, the ITA 84(2) dividend will be subtracted as follows:

| | |
|---|---|
| Total Distribution to Shareholders | $646,825 |
| ITA 84(2) Deemed Dividend | ( 636,825) |
| Deemed Proceeds Of Disposition | $ 10,000 |
| Adjusted Cost Base Of Shares | ( 10,000) |
| Capital Gain | Nil |

### Exercise Seventeen - 9

**Subject:** Winding-Up Of A Canadian Corporation

Windown Inc. is a Canadian controlled private company. After disposing of all of its assets and paying all of its liabilities, including Tax Payable resulting from the asset dispositions, the Company is left with cash of $865,000. The PUC of the Company's shares is equal to their adjusted cost base, an amount of $88,000. After the sale of assets, the Company has combined eligible and non-eligible RDTOH accounts of $47,000, a capital dividend account balance of $26,000, and a GRIP of nil. Determine the tax consequences to the shareholders associated with making the maximum distribution of cash to shareholders on the winding-up of Windown Inc. on June 1, 2019. Assume that appropriate elections will be made to minimize the taxes that will be paid by the shareholders.

**SOLUTION available in print and online Study Guide.**

**We suggest you work Self Study Problem Seventeen-7 at this point.**

# Convertible Properties

## Application

17-110. There is one more rollover that you should be familiar with. ITA 51 contains a provision that permits a holder of shares or debt of a corporation to exchange those securities for shares of that corporation on a tax free basis. For this rollover provision to apply, the following two conditions must be met:

- The exchange must not involve any consideration other than the securities that are being exchanged.
- The exchange must not be part of a reorganization of capital or a rollover of property by shareholders to a corporation under ITA 85 or ITA 86.

17-111. In practical terms, this provision is designed to accommodate a tax deferred conversion of debt or preferred shares of a corporation into preferred or common shares of the same corporation.

**EXAMPLE** An investor acquires convertible bonds with a par value of $10,000 at a price equal to par value. The bonds are convertible into 50 shares of the issuing company's common stock and, at the time of purchase, this common stock is trading at $18 per share (the conversion value of the bonds is $9,000). The bonds are converted when the common shares are trading at $22 per share.

**ANALYSIS** The conversion of the bonds is a disposition and, in the absence of a special provision, the tax consequences would be as follows:

| | |
|---|---|
| Proceeds Of Disposition [(50)($22)] | $11,000 |
| Adjusted Cost Base | ( 10,000) |
| Capital Gain | $1,000 |

17-112. The ITA serves to provide relief in this type of situation. ITA 51(1)(c), deems such exchanges not to be a disposition. Given this deeming provision, no gain will be recognized.

17-113. Going with this provision, ITA 51(1)(d) deems the cost of the acquired shares to be equal to the cost of the shares or debt given up. In effect, ITA 51 allows convertible securities to be converted with no immediate tax consequences. No gain or loss is recorded and the adjusted cost base of investors' securities remains unchanged.

## Other Considerations

17-114. A conversion provision can assist corporations seeking to add an equity kicker to enhance the marketability of their debt or preferred shares. In addition, conversion arrangements can be used to facilitate income splitting within a corporation. Different classes of shares can be used to allow the redistribution of income and, with the ability to convert different classes of shares on a tax deferred basis, an additional element of flexibility is introduced into such arrangements.

17-115. ITA 51.1 contains a similar provision to cover situations under which bondholders of a particular company are allowed to convert their holdings into a different debt security of that company. Here again, there is a tax deferred rollover with the adjusted cost base of the old bond holding becoming the creditor's adjusted cost base for the new debt security.

17-116. We would call your attention to the fact that the accounting rules on debt that is convertible into common or preferred shares require that the proceeds from its issuance be divided between the amount paid by investors for the liability component of the financial instrument and the amount paid for the equity option (see IAS 32, *Financial Instruments: Presentation*). This important issue has not, at this point in time, been given recognition in tax legislation. For tax purposes, the full amount received for convertible debt must be allocated to the debt component of the security.

# Sale Of An Incorporated Business

## Alternatives

17-117. Assume that you are the sole shareholder of an incorporated business and that you have decided to dispose of your company. If the business has a value that extends beyond your personal services, it should be possible to arrange a sale of the business. In approaching the problem of selling an incorporated business, you are usually confronted with the following three alternatives:

- Sale of the individual assets of the corporation, on a piecemeal basis.
- Sale of the total net assets of the corporation, including any unrecorded intangibles such as goodwill.
- Sale of the shares of the corporation.

17-118. In the next section, consideration will be given to the advantages and disadvantages, as well as to the tax effects that are associated with each of these alternatives. However, before turning our attention to these alternatives, some attention must be given to the tax treatment of restrictive covenants.

## Restrictive Covenants (a.k.a. Non-Competition Agreements)

### *General Rules*

17-119. Restrictive covenants are arrangements under which a taxpayer agrees to have his ability to provide goods or services restricted in one or more ways. Such agreements may relate to particular products or services (e.g., the taxpayer will not provide audit services) and may refer to specific geographic areas (e.g., the taxpayer will not provide audit services in the greater Calgary area). They may or may not be limited in terms of time. It is not uncommon, particularly in the case of owner-managed businesses, for the purchaser to require the seller to sign a restrictive covenant.

17-120. ITA 56.4(2) requires that, in general, 100 percent of payments made to a taxpayer for agreeing to a restrictive covenant be included in income as an "other source" under subdivision d. Fortunately for taxpayers, ITA 56.4(3) contains three important exceptions to this general rule.

### *Exceptions To 100 Percent Income Inclusion*

17-121. These exceptions are as follows:

**ITA 56.4(3)(a) - Employment Income** In cases where the payment relates to past employment with the payor, the receipt will be treated by the recipient as employment income. While 100 percent of the amount would still be subject to tax, classification as employment income would mean that it does not have to be included in the recipient's income until it is received (employment income is on a cash basis). When this exception is applicable, ITA 56.4(4)(a) allows the payor to treat the payment as wages paid or payable.

**ITA 56.4(3)(b) - Class 14.1** Provided the payor and recipient file a joint election, the restrictive covenant payment can be treated as an acquisition of a Class 14.1 asset by the payor, and as Class 14.1 proceeds of disposition by the recipient.

From the point of view of the payor, this is an unfavourable treatment. Instead of being a fully deductible expense, the payment is added to Class 14.1 where it will only be deductible on a 5 percent declining balance basis.

However, from the point of view of the recipient, this is a very favourable approach. As the intangible asset that is reflected in the restrictive covenant payment will normally have a capital cost of nil, the entire proceeds of disposition will be treated as a capital gain, only one-half of which will be taxable. In the absence of this treatment, the full amount of the restrictive covenant payment would be taxable to the recipient.

**ITA 56.4(3)(c) - Sale Of An Eligible Interest** An eligible interest is an interest in shares in a corporation that carries on business, or in a partnership that carries on business. In a situation where a restrictive covenant is sold in conjunction with an eligible interest, the amount received can be added to the proceeds of disposition. As was the case with the ITA 56.4(3)(b) exception, the payor and the recipient must file a joint election for this exception to apply. When this exception is applicable, ITA 56.4(4)(c) requires the purchaser to treat the payment as a cost of the purchase.

If this addition creates or increases a capital gain, only one-half of this amount will be subject to tax. Note that the application of this provision is more complex when there is more than one restrictive covenant involved in the sale of a single eligible interest.

17-122. The first of these exceptions, treatment of the restrictive covenant payment as employment income, is not relevant to the material in this Chapter. However, the other two exceptions are very significant when a business is being sold and will be given further attention in our discussion of the alternative ways in which a business can be sold.

## Sale Of Individual Assets

### General Procedures

17-123. Disposing of a business via a piece-by-piece sale of individual assets would only occur in certain situations. These could be described as follows:

- The business has not been successful in producing an adequate rate of return on the assets invested. In such situations, the most reasonable course of action may be the sale of individual assets.
- Some owner-managed businesses have income producing activities that are so closely tied to the skills of the owner/manager that the sale of the business independent of those skills would not be feasible.

17-124. This type of disposition would only be appropriate in limited circumstances. Given that the circumstances associated with the particular business will dictate whether this approach will be used, there is no need to devote any attention to the advantages or disadvantages of this alternative.

### Restrictive Covenants - Sale Of Individual Assets

17-125. In the situations that are involved here, it is unlikely that a restrictive covenant will be used. However, if this was to occur, treatment of the amount involved as an acquisition/disposition of a Class 14.1 asset would be possible. This treatment will be discussed in the next section dealing with the sale of total assets as a going concern.

## Sale Of Assets As A Going Concern

### General Procedures

17-126. In contrast to a liquidation, where the assets are sold on an individual basis, the purchaser in this situation would acquire the corporation's assets as a going concern and, in so doing, would acquire any goodwill or other intangible assets that might be associated with the enterprise.

17-127. As was the case with the piece by piece sale of individual assets in a liquidation, the sale of all assets as a going concern may result in a combination of business income, capital gains, recapture, and terminal losses.

17-128. In both types of asset sales, you should note that there are really two transactions involved. The first transaction involves the sale of assets and the payment of liabilities at the corporate level. Included in this process will be the determination of any tax liability resulting from the sale of the assets. At this point, the corporate assets would consist entirely of the after tax proceeds resulting from the disposition of the tangible and other assets of the corporation. In most situations, the owner will choose to distribute these assets and wind up the corporation.

17-129. This distribution of the after tax proceeds of the sale of corporate assets is the second transaction and, in general, it will involve income tax effects for the recipient shareholders. Given this two transaction process, a complete analysis of the alternatives of selling the assets of the business versus disposing of the shares will require dealing with both taxation on the corporation as a result of disposing of the assets, and personal taxation as a result of distributing the after tax proceeds of this sale.

17-130. In dealing with the sale of corporate assets, an understanding of the tax effects associated with such dispositions is required. These effects can be outlined as follows:

**Cash** In most circumstances, the cash of the business will be retained in the business. If it is "sold", there will be no tax consequences associated with its disposition.

**Accounts Receivable** In the absence of any special election, the sale of accounts receivable as a component of the sale of a business will be treated as a capital transaction. This means that any difference between the face value and the consideration received will be treated as a capital loss, only one-half of which will be deductible.

However, ITA 22 provides for a joint election to treat the sale of receivables as an income transaction. This allows the purchaser to treat any difference between the amount paid for the receivables and the amount actually collected as a bad debt expense. A more detailed description of this election is presented in Chapter 6.

**Inventories** Even when inventories are sold as part of the sale of a business, any difference between the sales price and the vendor's cost will be treated as ordinary business income. This is provided for in ITA 23 and, unlike the situation with the ITA 22 treatment of receivables, no election is required. For the purchaser, the transfer price becomes the tax cost that will eventually be allocated to cost of goods sold.

**Prepayments** The *Income Tax Act* does not recognize prepayments as an asset. This means that some amounts that are treated as prepayments in the accounting records have, for tax purposes, been deducted as expenses. As a result of this, when such balances are sold for their fair market value, the proceeds will be included in income.

**Non-Depreciable Capital Assets** The most common non-depreciable capital assets of a business are land and investments. Depending on the amount of consideration received for these assets, the transferor will have a capital gain or loss. With respect to capital losses, they can only be deducted from capital gains.

If some of the consideration being paid for these assets is deferred, the corporation can use capital gains reserves to defer part of the applicable taxation. However, the use of this technique would require continuing the corporation through the deferral period and this may not be in keeping with the objectives of the vendor.

For the purchaser, the adjusted cost base of non-depreciable capital assets will be the purchase price, which presumably is the fair market value.

**Depreciable Assets** The disposition of a depreciable asset can result in recapture, a terminal loss, or some combination of recapture and a capital gain. Unlike capital gains, recapture and terminal losses will be subject to 100 percent inclusion in, or deduction from, active business income and will be included in income eligible for the small business deduction.

As was the case with non-depreciable capital assets, if some of the consideration for these assets is not received immediately, reserves can be used to defer the taxation of capital gains.

For the purchaser, the capital cost of depreciable assets will be the purchase price, which presumably is the fair market value.

**Goodwill** If goodwill is present, some amount of the consideration received for the going concern will be allocated to goodwill. Any allocated amount will be treated as proceeds of disposition for a Class 14.1 asset. As the capital cost of goodwill will most commonly be nil, when the lesser of the proceeds of disposition and the capital cost of the goodwill is subtracted from any Class 14.1 balance, it commonly results in the entire proceeds of disposition allocated to goodwill being treated as a capital gain.

The purchaser of the going concern will add the allocated cost of the goodwill to Class 14.1 where it will be subject to CCA on a 5 percent declining balance basis. The AccII provisions are applicable to this Class.

## Restrictive Covenants - Sale Of Total Assets

17-131. Restrictive covenants may take one of two different forms when there is a sale of the total assets of the corporation. If it is anticipated that the corporation will continue in business, the agreement can be between the purchaser of the assets and the corporation. In contrast, if the corporation is to be liquidated, the agreement will likely be between the purchaser and the former owner(s) of the shares. It is also possible that the purchaser will require both the corporation and the former shareholders to sign a restrictive covenant.

17-132. This election is available only between the purchaser and the business (corporation or proprietorship). It could not be between the purchaser and the shareholders of the relevant corporation. This approach is conditional on the parties being prepared to make the required joint election.

17-133. If the election is made, the consideration given for the restrictive covenant will be treated as the proceeds of disposition of a Class 14.1 asset. As previously discussed, in most situations, this will result in the amount being treated as a capital gain.

17-134. If the payment is eligible for the joint election and the election is made, the purchaser will treat the payment for the restrictive covenant as the acquisition cost of a Class 14.1 asset. However, if the payment is not eligible, or if no joint election is filed, ITA 56.4 provides no specific guidance for the purchaser.

17-135. This means that the purchaser will have to apply basic principles from other Sections of the *Income Tax Act*. Without regard to the fact that the vendor will be taxed on the full amount of the payment under ITA 56.4(2), the purchaser's treatment may involve a deduction of the full amount of the payment, or an addition of the payment to one or more assets. The specific treatment by the purchaser will depend on the nature of the payment as determined under general tax principles.

## Sale Of Shares

### General Procedures

17-136. In terms of accounting, legal, and tax considerations, this is the simplest way to sell a business. The calculation of the gain on the sale only requires the adjusted cost base of the shares to be subtracted from the proceeds received from their disposition. Any resulting difference will be a capital gain or loss, and will be subject to the usual treatment accorded to share dispositions.

17-137. In preparing for the sale of shares, a corporation will declare tax-free capital dividends to the extent of its capital dividend account and taxable dividends for any additional amount which will generate a dividend refund if there is an RDTOH balance.

### Lifetime Capital Gains Deduction

17-138. If the corporation is a "qualified small business corporation" as defined in ITA 110.6(1), the disposition of shares may qualify for the lifetime capital gains deduction. The conditions associated with the designation "qualified small business corporation" are discussed in Chapter 11. Note here, however, that this deduction is only available on the sale of shares by an individual. If the shares are sold by a corporation, this valuable deduction is not available.

### Restrictive Covenants - Sale Of Shares

17-139. In cases where a business disposition involves a sale of shares, any restrictive covenant that is required will involve an agreement between the purchaser of the shares and the vendor of the shares. In this situation the exception under ITA 56.4(3)(c) (see Paragraph 17-121) becomes important. The sale of shares would be a disposition of an eligible interest and this would allow the taxpayer receiving payment for the restrictive covenant to include it as part of the proceeds of disposition. As such, it would serve to create or increase a capital gain on the sale, only one-half of which would be taxable.

17-140. Note that this treatment requires the vendor and purchaser to file a joint election and, if they fail to do so, the vendor will have to include the full amount of the payment in income when it is received or becomes receivable. If the election is filed, the purchaser will include the payment in the cost of his purchase. If the election is not filed, the treatment by the purchaser will require the application of general tax principles.

## Evaluation Of Alternatives

### Advantages Of Selling Shares

17-141. Generally speaking, the vendor of a business will favour selling shares over selling assets. Factors favouring this alternative are as follows:

- The sale of shares offers the simplicity of a single transaction. In contrast, in a sale of assets, the vendor must deal with the legal and tax consequences arising at the corporate level. In addition, the vendor must steer the corporation through a winding-up procedure and deal with the personal tax consequences of these procedures. The greater complexity will require additional personal efforts on the part of the vendor. Also, the legal and accounting fees associated with these transactions are likely to be significant.
- Any income produced by the sale of shares will usually be reported as capital gains. At worst, only one-half of such gains are taxable. At best, the taxable gains may be reduced or eliminated through the use of the lifetime capital gains deduction. If assets are sold by the corporation, some of the resulting income could be recaptured CCA, which must be included in income in full. In addition, if capital gains arise on the sale of assets, they will be treated as investment income to the corporation and will not be eligible for the small business deduction.
- If the enterprise has an unused non-capital loss carry forward, it will still be available to the enterprise if shares are sold. Any non-capital loss carry forwards are, of course, subject to the acquisition of control rules, requiring that they be applied against income earned in the same business in which the losses were incurred. However, if the sale of assets alternative is chosen, such loss carry forward balances will be completely unavailable to the purchaser.
- When a payment for a restrictive covenant is a component of the sale of shares, the vendor may be able to treat the amount received as an addition to his proceeds of disposition, rather than an amount that has to be fully included in income. This treatment is conditional on the vendor and purchaser filing a joint election, in which case the purchaser will add the amount paid to his acquisition cost.
- A sale of assets could result in the payment of land transfer taxes that would not be applicable if shares are sold.

### Advantages Of Purchasing Assets

17-142. As just described, there are a number of advantages that can be associated with selling shares, most of them benefitting the vendor. From the point of view of the purchaser, a purchase of assets is generally more desirable than a purchase of shares. Some of the advantages of purchasing assets are as follows:

- In acquiring assets, the purchaser acquires a completely new, and usually higher, set of tax values for the assets transferred. For example, consider a depreciable asset with a capital cost of $100,000, a UCC of $40,000, and a fair market value of $400,000. If shares are acquired, the CCA deductions available to the corporation will continue to be based on $40,000 and, if the assets are subsequently disposed of, capital gains will be determined from the original capital cost of $100,000. In contrast, if the asset was purchased in an arm's length transaction for its fair market value of $400,000, this amount would be the capital cost and UCC to the purchaser. This bump-up in asset values and the availability of higher CCA claims can significantly reduce the tax liabilities of the purchaser.
- Goodwill can be recognized when assets are acquired. The CCA deductions related to Class 14.1 are not available if shares are acquired.
- In situations where the purchaser has an existing corporation, he may prefer to have that corporation acquire the assets, rather than acquiring the shares of an additional corporation and incurring the administrative costs associated with maintaining a second corporation.

- If shares are acquired, all of the assets must be acquired. In a sale of assets, redundant assets can be left out of an acquisition of assets. Note, however, if there are unwanted assets, it is fairly common for these assets to be disposed of prior to the sale of shares.
- If shares are acquired, the existing liabilities of the corporation will continue to be in place. It is possible that the purchaser can obtain financing on more favourable terms, in which case he would prefer to acquire assets.
- If shares are acquired, the purchaser may become responsible for any future tax reassessments. While this exposure could occur because the purchased corporation continues to operate, it is usually covered in the buy and sell agreement for the transaction. This agreement is normally written to protect the purchaser from future problems in this area.
- A further problem relates to potential non-tax liabilities related to product or environmental liabilities. Again, because the purchased corporation is continuing to operate, it could be responsible for such liabilities. However, this is another issue that is normally dealt with in the buy and sell agreement.
- Most of the preceding discussion has implicitly assumed that the corporation's assets have fair market values in excess of their related tax values. If this is not the case and unrealized losses are present, selling assets may be advantageous to the vendor as well as the purchaser. This is based on the fact that the vendor would prefer to have fully deductible terminal or business losses, rather than capital losses that are only one-half deductible against taxable capital gains.

### Conclusion

17-143. While each situation needs to be evaluated on the basis of the specific assets and values involved, in general, a vendor will wish to sell shares while a purchaser will wish to acquire assets. As a result, negotiations will usually involve higher prices being offered for the assets of the business than are offered for the shares of the incorporated business.

## Example

17-144. To illustrate the sale of an incorporated business, we will use the following example.

> **EXAMPLE** Mr. O'Leary owns all of the outstanding shares of O'Leary Ltd., a Canadian controlled private corporation with a December 31 year end. Mr. O'Leary has reached retirement age and wishes to dispose of the business. He has received an offer to buy the shares for $180,000 or, alternatively, the assets of the business for $200,000. All of the liabilities of the business have been settled in preparation for the sale.
>
> The cost of Mr. O'Leary's original investment was $50,000. As no additional investment has been made, this is also his adjusted cost base and paid up capital for the outstanding shares. The provincial tax rate on business income eligible for the small business deduction is 2.5 percent. The provincial rate on all other income is 14 percent. The corporation has no balance in its RDTOH account, its capital dividend account, or its GRIP account. Mr. O'Leary is subject to a combined federal/provincial rate of 46 percent on non-dividend income and 31 percent on non-eligible dividends received.
>
> Relevant information on the January 1, 2019 values for the assets of the business is as follows:

| Asset | Cost | Fair Market Value |
|---|---|---|
| Cash | $ 5,000 | $ 5,000 |
| Receivables | 10,000 | 10,000 |
| Inventories | 55,000 | 60,000 |
| Land | 20,000 | 40,000 |
| Plant And Equipment (UCC = $45,000) | 95,000 | 60,000 |
| Goodwill | Nil | 25,000 |
| Total | $185,000 | $200,000 |

## Sale Of Shares For $180,000

17-145. With respect to the sale of shares, the tax consequences are as follows:

| | |
|---|---|
| Proceeds Of Disposition | $180,000 |
| Adjusted Cost Base | ( 50,000) |
| Capital Gain | $130,000 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain (For Mr. O'Leary) | $ 65,000 |

17-146. The after tax results for Mr. O'Leary are as follows:

| | |
|---|---|
| Proceeds Received | $180,000 |
| Tax Payable [(46%))($65,000)] | ( 29,900) |
| Cash Retained | $150,100 |

17-147. While this might be the result, it is likely that O'Leary Ltd. is a qualified small business corporation. If this is the case, the lifetime capital gains deduction could be used to eliminate all of the taxes on this disposition of shares, resulting in Mr. O'Leary retaining the entire $180,000 proceeds. Alternative minimum tax might be applicable if the capital gain is sheltered through the lifetime capital gains deduction.

## Sale Of Assets For $200,000

17-148. The tax consequences resulting from selling the assets are calculated as follows:

| Account | | Taxable Income |
|---|---|---|
| Inventories ($60,000 - $55,000) | | $ 5,000 |
| Plant And Equipment - Recaptured CCA ($60,000 - $45,000) | | 15,000 |
| Active Business Income | | $20,000 |
| Taxable Capital Gains | | |
| Land [(1/2)($40,000 - $20,000)] | $10,000 | |
| Goodwill [(1/2)($25,000)] | 12,500 | 22,500 |
| Corporate Taxable Income | | $42,500 |

17-149. The resulting Tax Payable would be calculated as follows:

| | |
|---|---|
| Federal Tax On: | |
| Active Business Income [(38% - 10% - 19%)($20,000)] | $ 1,800 |
| Investment Income [(38% - 10% + 10-2/3%)($22,500)] | 8,700 |
| Part I Tax | $10,500 |
| Provincial Tax On Active Business Income [(2.5%)($20,000)] | 500 |
| Provincial Tax On Investment Income [(14%)($22,500)] | 3,150 |
| Total Corporate Tax Payable | $14,150 |

17-150. The GRIP and RDTOH balances at the beginning of the year are both nil. This means that the only amount available for a dividend refund would be the addition to the Non-Eligible RDTOH for the refundable portion of the Part I tax paid on the asset dispositions. This amount would be the least of:

| | |
|---|---|
| • 30-2/3% Of Investment Income [(30-2/3%)($22,500)] | $ 6,900 |
| • 30-2/3% Of Taxable Income, Less Amount Eligible For Small Business Deduction [(30-2/3%)($42,500 - $20,000)] | $ 6,900 |
| • Part I Tax Payable | $10,500 |

17-151. The allocation to the capital dividend account would be as follows:

| | |
|---|---|
| Non-Taxable Portion Of Capital Gain On: | |
| Land [(1/2)($20,000)] | $10,000 |
| Goodwill [(1/2)($25,000)] | 12,500 |
| Capital Dividend Account | $22,500 |

17-152. Given the preceding analysis of the liquidation of the corporate assets, the net cash retained by Mr. O'Leary after the distribution of corporate assets can be calculated as follows:

| | |
|---|---|
| Proceeds Of Disposition - Sale Of Assets | $200,000 |
| Corporate Tax Payable (Before Dividend Refund) | ( 14,150) |
| Dividend Refund (Note) | 6,900 |
| Funds Available for Distribution | $192,750 |
| Paid Up Capital | ( 50,000) |
| ITA 84(2) Deemed Dividend | $142,750 |
| Capital Dividend (Balance In Account - Election Required) | ( 22,500) |
| Deemed Taxable Dividend | $120,250 |
| Tax Rate (On Non-Eligible Dividends Received) | 31% |
| Personal Tax Payable On Non-Eligible Dividend | $ 37,278 |

**Note** Technically, the dividend refund is the lesser of the $6,900 balance in the Non-Eligible RDTOH account and 38-1/3 percent of taxable dividends paid. However, given the size of the distribution in this example, it is clear that $6,900 will be the lower figure.

17-153. There would be no capital gain on the distribution as shown in the following:

| | |
|---|---|
| Total Distribution | $192,750 |
| ITA 84(2) Deemed Dividend | ( 142,750) |
| Deemed Proceeds Of Disposition | $ 50,000 |
| Adjusted Cost Base Of The Shares | ( 50,000) |
| Capital Gain | Nil |

17-154. Based on the preceding calculations, Mr. O'Leary's after tax retention from the sale of assets would be calculated as follows:

| | |
|---|---|
| Amount Distributed | $192,750 |
| Tax On Deemed Dividend | ( 37,278) |
| Cash Retained | $155,472 |

17-155. This amount is larger than the $150,100 that would be retained from a sale of shares if the resulting capital gain was subject to tax. However, it is significantly smaller than the $180,000 that would be retained from a sale of shares if the lifetime capital gains deduction could be used to eliminate the entire gain on the sale.

**We suggest you work Self Study Problem Seventeen-8 at this point.**

**Additional Supplementary Self Study Problems Are Available Online.**

## Key Terms Used In This Chapter

17-156. The following is a list of the key terms used in this Chapter. These terms, and their meanings, are compiled in the Glossary located at the back of the Study Guide.

Adjusted Cost Base
Amalgamation
Business Combination
Canadian Corporation
Control (IAS 27)
Convertible Property
Corporation
Disposition
Exchange Of Shares In A Reorganization (ITA 86)
Gift
Goodwill
Legal Stated Capital
Lifetime Capital Gains Deduction
Merger
Non-Share Consideration
Paid Up Capital
Parent Company
Proceeds Of Disposition
PUC
Qualified Small Business Corporation
Recapture Of CCA
Redemption Of Shares
Reorganization Of Capital (ITA 86)
Restrictive Covenant
Rollover
Share For Share Exchange (ITA 85.1)
Small Business Corporation
Subsidiary
Taxable Canadian Corporation
Terminal Loss
Vertical Amalgamation
Winding-Up Of A 90% Owned Subsidiary
Winding-Up Of A Canadian Corporation

## References

17-157. For more detailed study of the material in this Chapter, we refer you to the following:

| | |
|---|---|
| ITA 22 | Sale Of Accounts Receivable |
| ITA 23 | Sale Of Inventory |
| ITA 24 | Ceasing To Carry On Business |
| ITA 51 | Convertible Property |
| ITA 51.1 | Conversion Of Debt Obligation |
| ITA 54 | Definitions (Proceeds Of Disposition) |
| ITA 84(2) | Distribution on Winding-Up, Etc. |
| ITA 84(3) | Redemption Of shares |
| ITA 84(5) | Amount Distributed Or Paid Where A Share ... |
| ITA 85 | Transfer Of Property To Corporation By Shareholders |
| ITA 85.1 | Share For Share Exchange |
| ITA 86 | Exchange Of Shares By A Shareholder In Course Of Reorganization Of Capital |
| ITA 87 | Amalgamations |
| ITA 88(1) | Winding-Up (Of A 90 Percent Owned Subsidiary) |
| ITA 88(2) | Winding-Up Of A Canadian Corporation |
| ITA 110.6 | Capital Gains Exemption |

| | |
|---|---|
| S4-F3-C1 | Price Adjustment Clause |
| S4-F5-C1 | Share For Share Exchange |
| S4-F7-C1 | Amalgamations of Canadian Corporations |
| IT-115R2 | Fractional Interest In Shares |
| IT-126R2 | Meaning Of "Winding-Up" |
| IT-140R3 | Buy-Sell Agreements |
| IT-142R3 | Settlement Of Debts On The Winding-up Of A Corporation |
| IT-146R4 | Shares Entitling Shareholders To Choose Taxable Or Capital Dividends |
| IT-149R4 | Winding-Up Dividend |
| IT-188R | Sale Of Accounts Receivable |
| IT-243R4 | Dividend Refund To Private Corporations |
| IT-287R2 | Sale Of Inventory |
| IT-302R3 | Losses Of A Corporation - The Effect That Acquisitions Of Control, Amalgamations, And Windings-Up Have On Their Deductibility - After January 15, 1987 |
| IT-444R | Corporations — Involuntary Dissolutions |

# Problems For Self Study (Online)

To provide practice in problem solving, there are Self Study and Supplementary Self Study problems available on MyLab Accounting.

Within the text we have provided an indication of when it would be appropriate to work each Self Study problem. The detailed solutions for Self Study problems can be found in the print and online Study Guide.

We provide the Supplementary Self Study problems for those who would like additional practice in problem solving. The detailed solutions for the Supplementary Self Study problems are available online, not in the Study Guide.

The .PDF file "Self Study Problems for Volume 2" on MyLab contains the following for Chapter 17:

- 8 Self Study problems,
- 5 Supplementary Self Study problems, and
- detailed solutions for the Supplementary Self Study problems.

# Assignment Problems

(The solutions for these problems are only available in the solutions manual that has been provided to your instructor.)

### Assignment Problem Seventeen - 1

**(Section 85.1 Share For Share Exchange After ITA 85 Rollover)**

In 2011, Sandy O'Brien opened a business, Sandy's Frames, that specialized in providing frames for high end paintings and drawings. From 2011 through 2014, he operated the business as a proprietorship. He did not incorporate as he needed all of the income produced by the business to cover his living expenses.

However, by 2014 his profits had increased to the point where he no longer needed all of the income produced by the business. Given this, he decided to incorporate.

His accountant advised him that he could avoid current taxation by using the provisions of ITA 85(1) to transfer his business assets to the new corporation. To facilitate this, on January 1, 2015, the following values were established for the assets of the business.

| | |
|---|---|
| Tax Values Of The Business Assets | $1,820,000 |
| Fair Market Value Of The Business Assets | $3,140,000 |

On this date, the assets are transferred to a new corporation, Frames Ltd., at an elected value of $1,820,000. As consideration, Sandy took back a note payable for $900,000, redeemable preferred shares with a fair market value of $920,000, and 6,950 common shares with a fair market value of $1,320,000. No other shares were issued during the years under consideration.

Over the next few years, the business continues to expand and prosper and, on January 1, 2019, he receives an offer from Conglomerate Inc., a large public company, for all of the common shares. Under terms of this offer, Sandy will give up all of the common shares of Frames Ltd. in return for a separate class of shares issued by Conglomerate Inc. These shares have a fair market value of $1,970,000. In addition, subsequent to the exchange transaction, Sandy's preferred shares will be redeemed for $920,000. Frames Ltd. does not have GRIP balance or an RDTOH balance at this time. Sandy and the controlling shareholders of Conglomerate Inc. deal with each other at arm's length.

While Sandy has been very successful with his business, he has made a number of very bad real estate investments. As a consequence, as of January 1, 2019, he has a $420,000 net capital loss carry forward.

Assume that Frames Ltd. does not meet the criteria for qualification as a small business corporation.

**Required:**

A. Advise Sandy with respect to the tax consequences that would arise for him from the redemption of his preferred shares and the acceptance of the offer from the public company for the exchange of shares. Your answer should consider both the application of ITA 85.1 and opting out of this provision.

B. Indicate the adjusted cost base of the Frames Inc. common shares on the books of Conglomerate Ltd.

C. Advise Sandy as to the alternative approaches that could be used to utilize his net capital loss carry forward in conjunction with the share exchange.

### *Assignment Problem Seventeen - 2*

***(ITA 85(1) and ITA 86(1) Share Exchange)***

Homer Parsons opened an unincorporated retail business in 2012. This business, known as Parsons' Paranormal Services, provides services related to helping individuals make contact with dead loved ones.

Homer quickly gains a reputation for success in such matters and, by 2015, he has opened several locations in the city and retained a number of very wealthy clients. As a result, the business is producing income far in excess of his current needs. At this time, in order to defer current taxation, Homer decides to incorporate. His accountant advises him that he can do this on tax free basis by using the provisions of ITA 85(1).

On January 1, 2015, the assets of the business have tax values (adjusted cost base or UCC) which total $1,986,000. The estimated fair market value of these assets is $2,950,000. On this date the assets are transferred to a new corporation at an elected value of $1,986,000. As consideration for the business assets, Homer takes back a note payable for $1,500,000 and common shares with a fair market value of $1,450,000. The new company, named Parsons Paranormal Inc. (PPI), will have a December 31 year end.

In its corporate form, the business continues to operate very successfully and, on January 1, 2019, the assets have tax values of $7,347,000. Their fair market value total $8,450,000.

Homer has an adult son who appears to have paranormal skills superior to his own. His name is Orpheus and, since 2015, he has become increasingly active in the business. As Homer now has sufficient resources to retire comfortably, he would like to transfer the future growth of the business to Orpheus.

To accomplish this, he is going to exchange his common shares in PPI for $5,000,000 in cash, plus redeemable preferred shares with a fair market value of $3,450,000. Subsequent to this exchange, Orpheus will acquire 200 common shares in PPI at a total cost of $20,000.

PPI does not have a GRIP balance or an RDTOH balance on January 1, 2019.

**Required**:

A. Determine the tax consequences for Homer that will result from his exchange of shares. As part of your answer, you should indicate both the adjusted cost base and the PUC of his preferred shares.

B. Determine the tax consequences for Homer that would result from the redemption of his preferred shares on February 1, 2019 for their fair market value of $3,450,000.

### Assignment Problem Seventeen - 3

**(Section 86 Reorganization With Gift)**

Lartex Inc. was incorporated in 2010 to produce cutting edge sports clothing. At this time, the Company issued 20,000 common shares for cash of $50 per share. Of these shares, 15,000 were purchased by Lara Text, with the remainder being purchased by Bentley Rolls, an arm's length individual who was her mentor.

In 2014, Bentley dies suddenly while running a marathon. Lara acquires the 5,000 shares that were purchased by Bentley Rolls from his estate for $90 per share. In order to finance the firm's rapidly expanding operations, the Company issues an additional 5,000 shares to Lara for the same $90 per share price.

Lara has a son, Lance Text, whose dream is to make Lartex a household name. Starting in 2015, he seeks out the most challenging and rigorous courses in the business program at his university. During the following two years, he excels at his courses, especially his tax courses which he considers the most interesting and rewarding. To encourage him in his studies, during 2017, when the estimated fair market value of a share was $100, Lara gives Lance a gift of 2,500 shares of Lartex Inc.

On January 1, 2019, the fair market value of the Lartex Inc. shares has increased to $120 per share. By this time, Lance has become increasingly active in helping her with the operations of Lartex Inc. Given this, she would like to transfer the future growth in Lartex Inc. to Lance using the provisions of ITA 86.

In order to implement this transfer, she exchanges her 22,500 shares of Lartex Inc. for a $500,000 note and redeemable preferred shares with a fair market value of $2,000,000. The only remaining common shares will be the 2,500 shares owned by Lance. At this time, the Company does not have a GRIP balance.

**Required:**

A. Describe the immediate tax consequences of this transaction to Lara Text, including the following:

- the amount of any gift that Lara has made to Lance;
- the PUC of the new preferred shares;
- the adjusted cost base of the new preferred shares;
- the amount of any deemed dividends arising on the exchange; and
- any capital gain or loss resulting from the exchange of the common shares.

B. Describe the tax consequences of this transaction to Lance Text.

C. Describe the tax consequences of this transaction to Lara Text that would result from the immediate redemption of her newly issued preferred shares at their fair market value of $2,000,000. Ignore the possible use of the lifetime capital gains deduction.

### Assignment Problem Seventeen - 4

#### [ITA 86(1) And 86(2)]

Sanice Ltd. was incorporated by John San in 2008 with the investment of $850,000. In return for this investment, John San received a total of 42,500 common shares of the new corporation.

Between the date of its incorporation and January 1, 2015, no new common shares are issued by Sanice. On this date, Malcolm Shelton acquires all of the outstanding shares for $1,200,000 in cash.

By January 1, 2019, the common shares of Sanice Ltd. have increased in value to $35 per share, or a total value of $1,487,500 [($35)(42,500)]. Because of continuing health problems, Malcolm would like to retire. While he has received an offer from an arm's length party to buy the Sanice Ltd. shares for $1,487,500, Malcolm would prefer to transfer both control of the Company and future increases in its value to his 42 year old daughter, Darlene Shelton.

He is planning to apply ITA 86 to an exchange of shares and is considering two alternative scenarios for implementing this exchange.

> **Scenario One** Malcolm would exchange his 42,500 common shares for cash of $850,000, plus redeemable preferred shares with a legal stated capital of $637,500 and a fair market value of $637,500.
>
> **Scenario Two** Malcolm would exchange his 42,500 common shares for cash of $850,000, plus redeemable preferred shares with a legal stated capital of $437,500 and a fair market value of $437,500.

Immediately after the exchange of shares, Malcolm will have the Company issue 250 common shares at a cost of $35 per share to Darlene who will purchase these shares with funds of her own.

Sanice Ltd. is not a qualified small business corporation. The Company has a nil balance in its General Rate Income Pool (GRIP) account for all years under consideration.

**Required**: For each of the two suggested approaches determine:

A. The amount of the gift to a related party, if any, resulting from the exchange of shares.

B. The paid up capital of the newly issued preferred shares.

C. The adjusted cost base of the newly issued preferred shares.

D. The proceeds of redemption/disposition that Malcolm received for the old common shares of Sanice Ltd.

E. The immediate tax consequences for Malcolm of the reorganization of the capital of Sanice Ltd.

F. The tax consequences for Malcolm if the new Sanice Ltd. preferred shares are immediately redeemed for their fair market value.

### Assignment Problem Seventeen - 5

#### [Section 87 vs. Section 88(1)]

Hubble Inc. owns 100 percent of the shares of Palomar Ltd. Hubble has decided that it does not want Palomar to continue as a separate legal entity. It has asked your assistance on whether to absorb Palomar into its operations using ITA 87 or, alternatively, ITA 88(1).

At the time of this decision, Palomar Ltd. has the following asset values:

| Asset | Capital Cost | Tax Value | FMV |
|---|---|---|---|
| Equipment | $ 11,000 | $ 3,300 | $ 700 |
| Land | 154,000 | 154,000 | 192,000 |
| Goodwill | Nil | Nil | 22,000 |

There are no liabilities and no tax loss carry forwards.

Hubble acquired the shares of Palomar several years ago for $231,000. At that time, the Equipment was valued at its capital cost of $11,000 and the Land was valued at $209,000, for a total of $220,000. At that time, goodwill was estimated to be $1,000.

Palomar has paid $5,000 in dividends since its acquisition by Hubble.

**Required:** Outline what the tax consequences would be if:

A. Palomar was amalgamated into Hubble Inc. using Section 87.

B. Palomar was rolled into Hubble Inc. using a Section 88(1) winding-up.

## *Assignment Problem Seventeen - 6*

### *(Section 88(1) Winding-Up)*

In 2015, Acme Ltd. purchased all of the outstanding shares of Cross Industries for cash of $1,400,000. The assets of Cross Industries at the time of the acquisition had tax values of $1,250,000, and included a piece of land that was being held as a location for a possible second manufacturing facility. This land had been acquired in 2010 for $640,000 and, at the time Acme acquired the Cross shares, it had a fair market value of $705,000.

Acme believes that the operations of Cross Industries have become so integrated with its own, that it no longer makes sense to operate Cross as a separate entity. As a consequence, they are considering the possibility of absorbing Cross using an ITA 88(1) winding-up. At January 1, 2019, the tax values of the assets of Cross Industries total $1,270,000. The Company is still holding the land for the additional manufacturing facility and it now has a fair market value of $790,000. Cross Industries has paid Acme Ltd. dividends totaling $20,000 since its acquisition.

**Required**: Explain the tax implications of the proposed winding-up from the point of view of both Acme Ltd. and Cross Industries.

## *Assignment Problem Seventeen - 7*

### *(Winding-Up Of A Corporation)*

Hextone Ltd. is a Canadian controlled private corporation (CCPC) that has operated with great success in the action video game market for more than 20 years. The Company has a December 31 year end.

The founder and driving force behind the Company's success is Dread Hextone. As he has always been a loner with severe anger management issues, he has thought it too risky to ever marry knowing the potential for spouses to be aggravating.

Dread is 54 years old. In his family, every male has died of a stroke before reaching the age of 60. He has done a calculation which compares his anticipated expenditures during his remaining expected years of life with the resources that would result from winding up Hextone Ltd. He has concluded that these resources are more than sufficient to cover his anticipated expenditures. As the success of Hextone Ltd. is largely based on Dread's personal efforts, he would not be able to sell his shares. Given this, he intends to sell the assets of the company, followed by a wind-up and distribution of the resulting cash.

The following statement of the Company's net assets as of January 1, 2019 has been prepared:

**Hextone Ltd.**
**Statement Of Net Assets**
**As At January 1, 2019**

| | Tax Values | Fair Market Values |
|---|---|---|
| Cash | $ 72,356 | $ 72,356 |
| Investments | 1,728,460 | 2,135,450 |
| Inventories | 728,645 | 782,662 |
| Land | 427,400 | 687,300 |
| Building | 736,419 | 1,265,000 |
| Total Assets | $3,693,280 | $4,942,768 |
| Liabilities | ( 353,260) | ( 353,260) |
| Net Assets | $3,340,020 | $4,589,508 |

Based on tax values, the components of the net asset value balance are as follows:

| | |
|---|---|
| Paid Up Capital | $ 850,000 |
| Capital Dividend Account | 432,470 |
| Other Income Retained | 2,057,550 |
| Total Net Asset Balance | $3,340,020 |

**Other Information:**

1. The Building had a capital cost of $1,000,000.
2. The adjusted cost base of the common shares is equal to $850,000, their paid up capital.
3. On January 1, 2019, the Company has a balance in its General Rate Income Pool (GRIP) account of $86,400.
4. All of the assets are disposed of on January 1, 2019 at their fair market values. The corporation's liabilities are also paid on this date. The after tax proceeds from the sale are distributed to Dread on January 15, 2019.
5. The provincial tax rate for the corporation on income that qualifies for the small business deduction is 3 percent. On all other income, the provincial rate is 11.5 percent.
6. The January 1, 2019 balance in the Company's RDTOH account is $362,675.
7. No dividends were paid during the previous two years.

**Required:**

A. Calculate the amount that will be available for distribution to Dread after the liquidation.

B. Determine the components of the distribution to Dread, and the amount of taxable capital gains that will accrue to him as a result of the winding-up of Hextone Ltd. Ignore the possibility that Dread might be subject to the alternative minimum tax. Assume that appropriate elections or designations will be made to minimize the taxes that will be paid by Dread.

## Assignment Problem Seventeen - 8

***(Sale Of Assets vs. Shares)***

Mr. Robert Niche is the president and only shareholder of Niche Inc., a Canadian controlled private corporation. The Company's fiscal year ends on December 31. Mr. Niche established the Company 15 years ago by investing $344,500 in cash. There have been no other shares issued since then.

Mr. Niche is considering selling the corporation and, in order to better evaluate this possibility, he has prepared a special Statement Of Assets. In this special statement, comparative disclosure is provided for the values included in his accounting records, values that are relevant for tax purposes, and fair market values. This statement is as follows:

**Niche Inc.**
**Statement Of Assets**
**As At January 1, 2019**

| | Accounting Net Book Value | Tax Value | Fair Market Value |
|---|---|---|---|
| Cash | $ 70,850 | $ 70,850 | $ 70,850 |
| Accounts Receivable | 527,800 | 527,800 | 483,925 |
| Inventories | 1,130,675 | 1,130,675 | 1,268,800 |
| Land | 261,950 | 261,950 | 526,500 |
| Building (Note One) | 699,400 | 610,025 | 2,679,300 |
| Equipment (Note Two) | 564,200 | 382,200 | 222,625 |
| Goodwill | Nil | Nil | 1,054,300 |
| Totals | $3,254,875 | $2,983,500 | $6,306,300 |

**Note One** Mr. Niche built this Building on the Land for a total cost of $1,665,300.

**Note Two** The Equipment had a cost of $1,049,750.

At the same time that this Statement Of Assets was prepared, a similar Statement Of Equities was drawn up. This latter statement contained the following accounting and tax values:

| | Accounting Book Value | Tax Value |
|---|---|---|
| Current Liabilities | $ 906,100 | $ 906,100 |
| Loan From Shareholder | 178,750 | 178,750 |
| Future Income Tax Liability | 704,600 | N/A |
| Common Stock - No Par | 344,500 | 344,500 |
| Capital Dividend Account | N/A | 213,850 |
| Other Income Retained | N/A | 1,340,300 |
| Retained Earnings | 1,120,925 | N/A |
| Totals | $3,254,875 | $2,983,500 |

In addition to the information included in the preceding statements, the following other information about the Company is relevant:

- The Company has available non-capital loss carry forwards of $107,900.
- The Company has available a net capital loss carry forward of $168,545 [(1/2)($337,090)].
- Niche Inc. is subject to a provincial tax rate of 3 percent on income that qualifies for the federal small business deduction and 14 percent on income that does not qualify for this deduction.

- On December 31, 2018, the Company has no balance in either its RDTOH account or its General Rate Income Pool (GRIP) account.
- Niche Inc. shares are not qualified small business corporation shares.

Mr. Niche has received two offers for his Company, and he plans to accept one of them on January 2, 2019. The first offer involves a cash payment of $4,560,000 in return for all of the shares of the Company. Alternatively, another investor has expressed a willingness to acquire all of the assets, including goodwill, at a price equal to their fair market values. This investor would assume all of the liabilities of the corporation and has agreed to file an ITA 22 election with respect to the Accounts Receivable. If the assets are sold, it is Mr. Niche's intention to wind up the corporation.

Mr. Niche will have over $300,000 in income from other sources and, as a consequence, any income that arises on the disposition of this business will be taxed at the maximum federal rate of 33 percent, combined with a provincial rate of 18 percent. He lives in a province where the provincial dividend tax credit on eligible dividends is 5/11 of the gross up, and on non-eligible dividends is equal to 4/13 of the gross up.

**Required:** Determine which of the two offers Mr. Niche should accept. Ignore the possibility that Mr. Niche might be subject to the alternative minimum tax. Assume that appropriate elections or designations will be made to minimize the taxes that will be paid by Mr. Niche.

## *Assignment Problem Seventeen - 9*

### *(Sale Of Assets vs. Shares)*

Mr. Nathan Naper is the president and only shareholder of Nepean Ltd., a Canadian controlled private corporation. The Company's fiscal year ends on December 31. Mr. Naper established the Company 15 years ago by investing $265,000 in cash. There have been no other shares issued since then.

Mr. Naper is considering selling the corporation and, in order to better evaluate this possibility, he has prepared a special Statement Of Assets. In this special statement, comparative disclosure is provided for the values included in his accounting records, values that are relevant for tax purposes, and fair market values. This statement is as follows:

**Nepean Ltd.**
**Statement Of Assets**
**As At January 1, 2019**

| | Accounting Net Book Value | Tax Value | Fair Market Value |
|---|---|---|---|
| Cash | $ 54,500 | $ 54,500 | $ 54,500 |
| Accounts Receivable | 406,000 | 406,000 | 372,250 |
| Inventories | 869,750 | 869,750 | 976,000 |
| Land | 201,500 | 201,500 | 405,000 |
| Building (Note One) | 538,000 | 469,250 | 2,061,000 |
| Equipment (Note Two) | 434,000 | 294,000 | 171,250 |
| Goodwill | Nil | Nil | 811,000 |
| Totals | $2,503,750 | $2,295,000 | $4,851,000 |

**Note One** Mr. Naper built this Building on the Land for a total cost of $1,281,000.

**Note Two** The Equipment had a cost of $807,500.

At the same time that this Statement Of Assets was prepared, a similar Statement Of Equities was drawn up. This latter statement contained the following accounting and tax values:

| | Accounting Book Value | Tax Value |
|---|---|---|
| Current Liabilities | $ 697,000 | $ 697,000 |
| Loan From Shareholder | 137,500 | 137,500 |
| Future Income Tax Liability | 542,000 | N/A |
| Common Stock - No Par | 265,000 | 265,000 |
| Capital Dividend Account | N/A | 164,500 |
| Other Income Retained | N/A | 1,031,000 |
| Retained Earnings | 862,250 | N/A |
| Totals | $2,503,750 | $2,295,000 |

In addition to the information included in the preceding statements, the following other information about the Company is available:

- The Company has available non-capital loss carry forwards of $83,000.
- The Company has available a net capital loss carry forward of $129,650 [(1/2)($259,300)].
- Nepean Ltd. is subject to a provincial tax rate of 3 percent on income that qualifies for the federal small business deduction and 14 percent on income that does not qualify for this deduction.
- On December 31, 2018, the Company has no balance in either its RDTOH account or its General Rate Income Pool (GRIP) account.
- Nepean Ltd. is not a qualified small business corporation.

Mr. Naper has received two offers for his Company, and he plans to accept one of them on January 2, 2019. The first offer involves a cash payment of $3,508,000 in return for all of the shares of the Company. Alternatively, another investor has expressed a willingness to acquire all of the assets, including goodwill, at a price equal to their fair market values. This investor would assume all of the liabilities of the corporation and has agreed to file an ITA 22 election with respect to the Accounts Receivable. If the assets are sold, it is Mr. Naper's intention to wind up the corporation.

Mr. Naper will have over $300,000 in income from other sources and, as a consequence, any income that arises on the disposition of this business will be taxed at the maximum federal rate of 33 percent, combined with a provincial rate of 18 percent. He lives in a province where the provincial dividend tax credit on eligible dividends is 5/11 of the gross up, and on non-eligible dividends is equal to 4/13 of the gross up.

**Required:** Determine which of the two offers Mr. Naper should accept. Ignore the possibility that Mr. Naper might be subject to the alternative minimum tax. Assume that appropriate elections or designations will be made to minimize the taxes that will be paid by Mr. Naper.

# CHAPTER 18

# Partnerships

## Introduction

### Taxable Entities In Canada

18-1. As is noted in Chapter 1, the *Income Tax Act* (ITA) is applicable to individuals (human beings), corporations, and trusts. In the case of individuals and corporations, these taxable entities have a separate legal existence. In contrast, trusts are simply arrangements for transferring property and, as such, are not separate legal entities. Partnerships are similar to trusts in that they do not have a legal existence separate from the participating partners. More to the point here is the fact that, under the provisions of the *Income Tax Act*, partnerships are generally not defined taxable entities. An exception to this is "SIFT Partnerships" which are taxable under Part IX.1 of the *Act* (see discussion at the end of this Chapter).

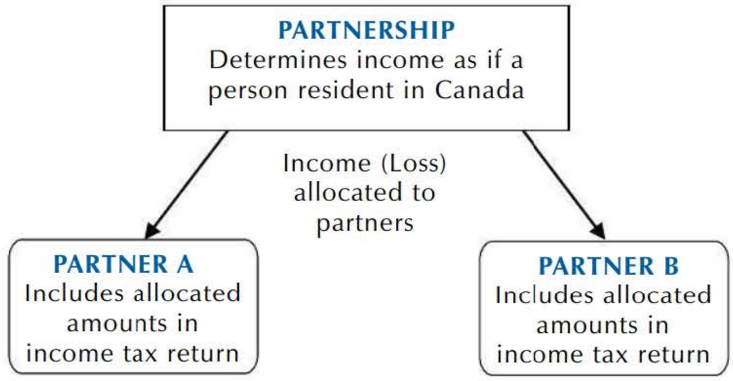
18-2. The *Income Tax Act* deals with the fact that partnerships are generally not taxable entities through the use of a deeming rule. A deeming rule is a statutory fiction that requires an item or event be given a treatment for tax purposes that is not consistent with the actual legal nature of the item or event. We have encountered several such rules in previous chapters:

- A member of the Canadian armed forces is deemed to be a resident of Canada, even if he does not set foot in the country during the year.
- A change in use is deemed to be a disposition of an asset combined with its immediate re-acquisition.
- The death of an individual results in a deemed disposition of all of his capital property.

18-3. The deeming rule that is applicable to partnerships is that, for purposes of determining the income or loss of its members, such organizations are considered to be a person resident in Canada. Note that this rule applies only for the purpose of calculating the income or loss of members. It does not make a partnership a taxable entity and there is no requirement that these organizations file a separate income tax return.

18-4. In general terms, a partnership is treated as a flow-through entity. The preceding deeming rule requires that an income figure be determined at the partnership level using the usual rules for various types of income (e.g., business income, property income, capital gains). Then the income or loss of the partnership is allocated to the taxable entities (i.e., individuals, trusts, or corporations) based on the amounts agreed to in the partnership agreement, or in equal proportions in the absence of a partnership agreement. This process is illustrated in Figure 18-1 (following page).

**Figure 18 - 1**
**Taxation Of Partnership Income**




18-5. We would note that, while partnerships are not taxable entities under the *Income Tax Act*, they are considered taxable entities for GST purposes (see Chapter 21). This means that, in contrast with the income tax situation, a partnership must file a GST return, pay any GST owing or is entitled to receive any GST refund.

## Chapter Coverage

18-6. In this Chapter we will examine the income taxation rules that are applicable to partnerships. We will begin by defining partnerships. This will be followed by an examination of the various types of partnerships, as well as other arrangements that resemble partnerships. These other arrangements include co-ownerships, joint ventures, and syndicates. Our focus will then shift to looking at the rules for calculating income for a partnership and the process of allocating this income and other amounts to partners.

18-7. Other issues that will be covered include:

- the determination of the adjusted cost base of a partnership interest;
- admitting and retiring partners;
- limited partnerships, limited partnership losses and the at-risk rules;
- the transfer of property between the partners and the partnership; and
- reorganizing a partnership as a new partnership, as a corporation, and as a sole proprietorship.

# Partnerships Defined

## The Importance Of Defining A Partnership

18-8. The general rules for determining the income tax consequences for partnerships and their members are found in Subdivision j of Division B of Part I of the *Income Tax Act*, ITA 96 through 103. However, since these rules apply specifically to partnerships, we must first determine if we are, in fact, looking at a partnership. To do this requires a definition of a partnership.

18-9. The importance of this definition is that it allows us to distinguish a partnership from other similar types of organizations such as syndicates, joint ventures, and co-ownership arrangements. This is necessary in that, unlike the situation for these other types of organizations, there is a separate calculation of the income of a partnership.

18-10. As we have noted, this calculation must be carried out using the assumption that the partnership is a separate person resident in Canada. Further, as the calculation must be used for allocating income to all of the members of the partnership, partners have no flexibility with

respect to the amounts to be included in their required tax returns. For example, a partner does not have the discretion to take an alternative amount of CCA on property owned by the partnership. Note, however, they do have discretion with respect to CCA on property that is used by the partnership, but owned by the partner (e.g., partial use of a personally owned automobile for partnership business).

18-11. In contrast, if the organization is considered to be a co-ownership, syndicate, or joint venture (see Paragraph 18-24), there is no requirement for a separate calculation of income. This provides the participants with much greater flexibility in determining the tax procedures to be used. In this case, one participant could take maximum CCA, while others take a lower amount, or even none at all.

## Basic Partnership Elements

18-12. Unfortunately, there is no specific definition of a "partnership" in the *Income Tax Act*. There are several definitions of certain types of partnerships. For example, ITA 102(1) defines a "Canadian Partnership" and ITA 197(1) defines a "SIFT Partnership". However, all of these specialized definitions presume that a partnership already exists. This leaves the question of defining a partnership unanswered.

18-13. Guidance on defining a partnership is provided in IT Folio S4-F16-C1, *What Is A Partnership?*. This Folio notes that "whether a partnership exists is a matter of fact and law". It then proceeds to discuss provincial law dealing with this issue, as well as several court cases that have bearing on this issue. What we would gather from reading through this material is that there are three basic elements that are required for an organization to be considered a partnership and these are:

1. There must be two or more persons (individuals, corporations or trusts) involved.
2. These persons must be carrying on a business in common.
3. It must be the intent of the partners to carry on a business with a view to making a profit.

18-14. Also helpful in this area, IT Folio S4-F16-C1 quotes a Supreme Court Case (Backman v. Canada, 2001 DTC 5149) which lists factors that would be viewed as providing evidence of the existence of a partnership:

- the contribution by the parties of money, property, effort, knowledge, skill or other assets to a common undertaking;
- a joint property interest in the subject matter of the adventure;
- the sharing of profits and losses;
- a mutual right of control or management of the enterprise;
- financial statements prepared as a partnership;
- bank accounts in the name of the partnership; and
- correspondence with third parties as a partnership.

18-15. The presence of a valid partnership agreement would serve to support the view that a partnership exists. Such agreements will usually include provisions that deal with many issues, including the following:

- the initial and ongoing partner contributions and ownership percentage of each partner,
- the responsibilities of each partner and the division of work between the partners,
- how income and drawings will be allocated and how much compensation is to be paid,
- signing authority on the partnership bank accounts and required approval for purchases,
- procedures for bringing in new partners, and
- procedures to deal with the withdrawal or death of a partner, or the sale of the business.

## Types Of Partnerships

### General Partnerships

18-16. A general partnership is one in which all of the partners are general partners. As defined in the *Guide For The T5013 Partnership Information Return* (T4068):

A **general partner** is a partner whose personal liability for the debts and obligations of the partnership are not limited.

18-17. Provincial partnership law provides additional guidance on the rights, duties and obligations of general partners. These include:

- Each partner is considered to act on behalf of the partnership, which means that the actions of each partner are generally binding on the other partners.
- Partners are jointly and severally liable for partnership debt and wrongful acts of other partners. This means that a partner can be liable, together with all other partners, for unpaid partnership debt and wrongful acts of other partners.
- Property contributed to the partnership or acquired with partnership funds is considered partnership property and is to be held exclusively for partnership use.
- Partners are entitled to share equally in profits and losses, unless there is an agreement to the contrary.
- Partners are not entitled to remuneration (salary or wages) or to interest on capital contributions. As is explained later in this Chapter, any remuneration or interest on capital is treated as an income allocation and is not deductible to the partnership.

18-18. When the term partnership is used without a qualifying adjective, the reference is normally to a general partnership.

### Limited Partnerships

18-19. A limited partnership is a partnership with at least one general partner (i.e., a partner whose liability is unrestricted) and one or more limited partners. To be considered a limited partnership, the partnership has to be registered as such under the appropriate provincial registry. In the absence of such registration, the partnership will be considered a general partnership.

18-20. A limited partner has the same rights, duties, and obligations as a general partner with one important difference, a limited partner is only liable for partnership debt and wrongful or negligent actions of other partners to the extent of the partner's actual and promised contributions to the partnership.

**EXAMPLE** A limited partner contributes $1,000 and agrees to contribute a further $2,000 within a certain period of time. That partner will be potentially liable for up to $3,000 of claims against the partnership.

18-21. It should be noted, however, that a limited partner will lose his limited liability protection, and therefore become a general partner, if he participates in the management of the partnership.

### Limited Liability Partnerships (LLP)

18-22. This form of partnership is only available to certain types of professionals as specified in provincial legislation. For example, in Ontario, only lawyers and chartered professional accountants are currently permitted to form such partnerships. In contrast, Alberta extends this legislation to include several other professional groups.

18-23. Unlike members of limited partnerships, members of limited liability partnerships are personally liable for most types of partnership debt. There is, however, an important exception. Members of limited liability partnerships are not personally liable for obligations arising from the wrongful or negligent action of:

- their professional partners; or
- the employees, agents or representatives of the partnership who are conducting partnership business.

**We suggest you work Self Study Problem Eighteen-1 at this point.**

# Co-Ownership, Joint Ventures, And Syndicates

## Introduction

18-24. Our major concern in this Chapter is the taxation of partnerships. However, as we have noted, there are other types of organizations that have structures similar to partnership arrangements. Co-ownership, joint ventures, and syndicates are specific types of arrangements that contain features common to partnerships. For example, each of these organizational structures requires two or more persons. This common feature is but one of several that may make it difficult to determine whether a specific arrangement is, in fact, a partnership or, alternatively, a different type of arrangement.

18-25. As was discussed in the preceding material, the ability to distinguish these arrangements from partnerships is a critical factor in determining how a given organization will be taxed. To facilitate this process, the following material will provide additional clarification as to the nature of these other types of organizations.

## Co-Ownership

18-26. Two or more persons co-own property when they share a right of ownership in the property. For income tax purposes, the most important consideration is that profits and losses are shared in partnerships, but are typically accounted for individually by joint or co-owners.

18-27. Two common forms of co-ownership are joint tenancy and tenancy in common. A joint tenancy is a form of property ownership where two or more joint tenants have ownership and possession of the same property. Individual interests are identical and the property cannot be sold or mortgaged without the consent of the other joint tenant(s). Spouses commonly own their principal residence and other properties in joint tenancy.

18-28. In a tenancy in common arrangement, tenants can sell or mortgage their interests without the consent of other tenants in common. An example of a situation where a tenancy in common might be used would be the ownership of a vacation property by three brothers.

## Joint Ventures

### *Defined*

18-29. Those of you familiar with financial reporting will recognize that some corporations are referred to as joint ventures. They are distinguished by the fact that control of the corporation is shared by two or more of the shareholders. This type of joint venture does not present any special problems in terms of tax procedures. They are subject to the same rules that are applicable to other corporate taxpayers.

18-30. Our concern here is with unincorporated joint ventures. Like partnerships, joint ventures are not defined taxable entities under the *Income Tax Act*. Further, such arrangements are not governed by provincial legislation. However, both the *Income Tax Act* and the *Excise Tax Act* refer to joint ventures, implicitly giving recognition to this form of organization.

18-31. The similarity of partnerships and joint ventures has led the CRA to make the following statement in 1988:

> Unlike partnerships, the concept of joint venture is not recognized by statute (i.e. provincial legislation). Although the Canadian courts have, in certain cases, recognized joint venture as being a business relationship that is distinct from partnership, in our experience, many so-called joint ventures are in fact partnerships... The CRA would rely on provincial partnership law in making such a determination.

18-32. This would suggest that, even if participants in a joint venture call the arrangement a joint venture, if it contains the three basic partnership elements, it will be considered a partnership for tax purposes and treated accordingly.

18-33. Despite this lack of clarity, joint ventures do appear to exist for tax purposes. Factors that have been used to distinguish this type of organization include:

- co-venturers contractually do not have the power to bind other co-venturers;
- co-venturers retain ownership of property contributed to the undertaking;
- co-venturers are not jointly and severally liable for debt of the undertaking;
- co-venturers share gross revenues, not profits; and
- while partnerships may be formed for the same purpose as a joint venture, they are usually of longer duration and involve more than a single undertaking.

### *Tax Procedures*

18-34. If an arrangement is considered to be a joint venture rather than a partnership, there will be no separate calculation of income at the organization level. The participants will be subject to the usual rules applicable to individuals or corporations. As we have noted, this will provide these taxable entities with greater flexibility on such issues as how much CCA can be taken for the current year. You should note, however, since joint ventures are not a recognized entity for tax purposes, they cannot have their own fiscal period.

## Syndicates

18-35. A syndicate is generally defined as a group of persons who have agreed to pool their money or assets for some common purpose. Because a syndicate is not a legal entity, a reference to an interest in a syndicate usually means an interest in the combined assets of the syndicate members. The Canadian courts have traditionally reserved the name "syndicate" for specialized projects that are financial in nature. An example of a syndicate would be an association of insurance companies who combine forces to underwrite substantial high-risk insurance policies.

18-36. There are no specific income tax rules that apply to syndicates. This means that, if there are any activities of the syndicate that result in assessable amounts of income, the relevant amounts will have to be allocated to the members of the syndicate.

**We suggest you work Self Study Problem Eighteen-2 at this point.**

# Partnership Income, Losses, And Tax Credits

## Introduction

18-37. The goal of partnership taxation is to apply the income tax consequences of partnership income, losses, and tax credits to the persons who are its partners. To implement this, a two stage process is involved:

> **Stage 1** Determine, at the partnership level, the various components of partnership income. This requires separate calculations for business income, property income, taxable capital gains, and allowable capital losses. For most partnerships, the most important component will be net business income.
>
> **Stage 2** Allocate the amounts that were determined in Stage 1 to the members of the partnership on the basis of the provisions of the partnership agreement.

18-38. In determining the business income component, we generally begin with the partnership's accounting figure for business income. The normal procedure is to convert this figure to Net Business Income for tax purposes. This conversion is based on a reconciliation process which is very similar to the reconciliation process that is used to determine Net Business Income For Tax Purposes (see Chapter 6). There are, however, some items that are specific to the calculation of business income for partnerships.

18-39. Following the determination of the amount of business income to be allocated to partners, separate calculations are carried out for amounts of property income, taxable capital gains, and allowable capital losses that will be allocated to the members of the partnership.

18-40. While it would be possible to calculate a Net Income For Tax Purposes for the partnership, this usually is not done. Such a figure has no real meaning for a non-taxable entity such as a partnership. Further, the calculation would serve no real purpose as the allocations to the partners are on a source-by-source basis. We would also note that there is no calculation of Taxable Income for a partnership. Again, as partnerships are not taxable entities, such a figure would have no real meaning.

## Applicable Concepts

### *Taxation Year*

18-41. ITA 96(1)(a) indicates that partnership income must be calculated as if the partnership was a separate person resident in Canada. ITA 96(1)(b) follows this by indicating that this calculation should be made as if the taxation year of the partnership were its "fiscal period". The ITA 249.1(1) definition of "fiscal period" indicates that, if any member of a partnership is an individual or a professional corporation, the partnership must have a December 31 year end. Otherwise, the only restriction is that the fiscal period cannot end more than 12 months after it begins. In effect, this means that, if all of the members of a partnership are corporations (other than professional corporations), the partnership can use any year end.

18-42. ITA 249.1(4) provides an exception to the general taxation year end rules that are described in the preceding paragraph. If the following conditions are met, the partnership can elect to use a non-calendar year as its fiscal period.

- all of the members of the partnership are individuals; and
- an election is filed with the CRA using a prescribed form (T1139) prior to the end of the partnership's first fiscal year. The complications associated with making this election are discussed in Chapter 6, Business Income.

**EXAMPLE** ABC Partnership has five corporate partners, two of which are professional corporations, and one partner who is an individual. The new partnership wants to choose a March 31 fiscal year end.

**ANALYSIS** The partnership must use a December 31 fiscal year end. The presence of both an individual and professional corporations as partners prevents the use of a non-calendar fiscal period under the ITA 249.1(1) definition. Similarly, the presence of corporations prevents the election of a non-calendar fiscal period under ITA 249.1(4).

18-43. The CRA has been concerned with the ability of a corporate member of a partnership to defer taxes because it has a different year end from the partnership. Consider a partnership that has a fiscal year ending on January 31, 2019 and a corporate member with a December 31, 2019 year end. The corporation would not have to include the partnership income earned during the year ending January 31, 2019 until it files its return for the fiscal year ending December 31, 2019, despite the fact that most of that income was earned in the corporation's year ending December 31, 2018. In effect, this provides an 11 month deferral of income recognition.

18-44. To deal with this problem, special rules are applicable in situations where a partnership has a fiscal period that ends after the taxation year end of a corporation that has a significant interest (more than 10 percent) in that partnership.

18-45. The rules would require income adjustments similar to those required for "additional business income" which is covered in Chapter 6, Business Income.

18-46. In the example from Paragraph 18-42, the legislation requires the corporation to include 334/365 of the partnership income for its year ending January 31, 2019 in its corporate tax return for the year ending December 31, 2018. This accrual would be deducted in the corporate taxation return for the year ending December 31, 2019, with a new accrual added for 334/365 of the partnership income for the year ending January 31, 2020.

## Partnership Property

18-47. In general, partners legally own a percentage interest in partnership property in co-ownership. The partnership cannot own property since it is not a legal entity. This creates a problem for income tax purposes because the partnership income tax rules require that the partnership determine its income or loss as if it were a separate person.

18-48. If the partnership does not own partnership property, then gains and losses from the disposition of such property would not be considered those of the partnership. In addition, the partnership would not be able to claim CCA. The *Income Tax Act* resolves this problem with an assumption that the partnership, for income tax purposes, is considered to own partnership property.

## Retention Of Income Characteristics

18-49. Partnerships are treated as a conduit for transferring income from an originating source into the hands of the partners. Further, it is an unfiltered conduit in that the character of various types of income is not altered as it flows to the partners. If a partnership earns dividend income, capital gains, or realizes a business loss, these sources would be received as dividend income, capital gains, or business losses in the hands of the partners.

> **EXAMPLE** Partnership Deux has two equal general partners. Aside from its business income, Deux earns $50,000 of interest income and realizes a $20,000 capital gain. None of this amount is withdrawn by the two partners. Corporation Dos has two equal shareholders. It also earns $50,000 of interest income and realizes a $20,000 capital gain. The corporation does not pay out any of this amount as dividends.
>
> **ANALYSIS - Partnership** For Partnership Deux, each partner is considered to have received $25,000 [(1/2)($50,000)] of interest income and to have realized a $5,000 taxable capital gain [($20,000)(1/2)(1/2)]. Note that the income is subject to taxation, despite the fact that none of it has been withdrawn from the partnership (see next section on Accrual Basis).
>
> **ANALYSIS - Corporation** In the case of Corporation Dos, the shareholders will not be taxed until the income is withdrawn from the corporation. The income will, however, be taxed at the corporate level on the basis of its nature (e.g., capital gains, business, or property income). When it is distributed to the shareholders, it will not retain its characteristics as capital gains, business, or property income. Rather, the entire distribution will be taxed in the hands of the shareholders as dividends.

18-50. In addition to retaining its basic character, the originating location of each source of income is retained. If, for example, a partnership earns dividends on shares of U.S. corporations, this income would be received by the partners as foreign source dividends. Not surprisingly, the related foreign tax credits would also be flowed through to the partners.

## Accrual Basis

18-51. The partnership must calculate its net business income on an accrual basis unless its partners are professionals who can elect under ITA 34 to use the billed basis of income recognition (as noted in Chapter 6, the use of the billed basis of income recognition is being phased out). On its determination, this income is then allocated to the partners. The partners include their share of this income at the time of allocation, without regard to when the funds are withdrawn from the partnership. It is the allocation, not the receipt of the funds, which creates income for the partners that is subject to tax.

18-52. In effect, this places the partners on an accrual basis for the determination of their individual business income amounts. While drawings of cash from the partnership reduce the partner's adjusted cost base, they will have no impact on the partner's Taxable Income or the amount of taxes the partner will be required to pay.

## Exercise Eighteen - 1

**Subject:** Partnership Income - Accrual Basis

During the year ending December 31, 2019, PQR Partnership has business income of $55,000, capital gains of $40,000, and receives eligible dividends of $10,000. Norm Peters has a 50 percent interest in the income of this partnership. During 2019, Norm withdraws $30,000 from the partnership. Determine the tax consequences for Mr. Peters for the 2019 taxation year.

**SOLUTION available in print and online Study Guide.**

## Calculating The Amounts To Be Allocated

### *Net Business Income*

18-53. For most partnerships, the major income source to be allocated is the partnership's Net Business Income. As we have noted, this is a reconciliation process which starts with accounting Net Income. Various items are then added or subtracted to arrive at the partnership's Net Business Income. A discussion of the major items in this reconciliation process follows.

**Salaries Or Wages To Partners (Add Back)** Partnership agreements often provide that partners be paid salaries or wages to recognize the time they devote to partnership business. Reflecting provincial partnership legislation, the CRA does not permit the deduction of such amounts in the determination of a partnership's Net Business Income.

If salaries or wages have been deducted in determining the accounting Net Income of the partnership, they must be added back in the determination of Net Business Income for tax purposes of the partnership. While this is required in determining the total Net Business Income, it does not prevent priority allocations of this total to specific partners to reflect the work they do for the partnership. If the partnership agreement calls for such salary or wages entitlements for specific partners, the specified amounts will be allocated to those partners, with only the remaining Net Business Income allocated by some formula (e.g., a 60:40 split of the residual).

A further point here relates to whether the salaries or wages are withdrawn from the partnership. The allocated amount is included in the partner's income and added to his adjusted cost base. If, as would be the usual situation, the amounts are withdrawn from the partnership, they reduce the partner's adjusted cost base, but do not influence the partner's Net Income For Tax Purposes.

**Interest On Partner Capital Contributions (Add Back)** The preceding analysis of the treatment of partner salaries is also applicable to interest on capital contributions. If the partnership agreement calls for such amounts, they cannot be deducted in the determination of the Net Business Income of the partnership.

If interest payments on partner capital contributions have been deducted in the determination of accounting Net Income, they must be added back to arrive at the partnership's total Net Business Income. If the partnership agreement indicates that such amounts be treated as a priority allocation of the partnership's total Net Business Income, they will be included in the partner's Net Income For Tax Purposes and added to his adjusted cost base. If the specified amounts are withdrawn, the withdrawal does not affect the partner's Net Income For Tax Purposes. The drawings would, however, be deducted from the partner's adjusted cost base.

**EXAMPLE - Salaries And Interest On Capital Contributions** Bob and Ray are partners who share the Net Business Income of their partnership equally after a provision has been made for their salaries and Ray's interest on his capital

contributions. For the year ending December 31, 2019, the Income Statement of the partnership, prepared in accordance with GAAP, is as follows:

| | | |
|---|---|---|
| Revenues | | $135,000 |
| Expenses: | | |
| Cost Of Sales | ($45,000) | |
| Salary To Bob | ( 30,000) | |
| Salary To Ray | ( 10,000) | |
| Interest On Ray's Capital Contributions | ( 11,000) | |
| Other Expenses | ( 10,000) | ( 106,000) |
| Accounting Income | | $ 29,000 |

**ANALYSIS** For tax purposes, the Net Business Income of the Bob And Ray Partnership would be calculated as follows:

| | |
|---|---|
| Accounting Income | $29,000 |
| Add: | |
| Salaries To Bob and Ray ($30,000 + $10,000) | 40,000 |
| Interest On Capital Contributions | 11,000 |
| Net Business Income | $80,000 |
| Allocations For Salaries And Interest On Capital Contributions ($40,000 + $11,000) | ( 51,000) |
| Residual Net Business Income (To Be Shared Equally) | $29,000 |

This amount would be allocated to the two partners as follows:

| | Bob | Ray |
|---|---|---|
| Priority Allocation For Salaries | $30,000 | $10,000 |
| Priority Allocation For Interest | N/A | 11,000 |
| Allocation Of Residual On Equal Basis [(50%)($29,000)] | 14,500 | 14,500 |
| Total Business Income Allocation | $44,500 | $35,500 |

Despite the fact that the partnership agreement may refer to salaries or wages and/or for interest on capital for the partners, from a legal point of view they are allocations of Net Business Income. Given this, the usual payroll procedures (e.g., source deductions) are not required on the salaries or wages.

**Drawings (Add Back)** Drawings by partners are not deductible expenses in the determination of any type of partnership income. As GAAP for partnerships is not clearly laid out, partnership drawings may or may not be deducted in the determination of accounting Net Income. To the extent they have been deducted in determining accounting income, they will have to be added back in the determination of the partnership's Net Business Income.

**Dividend Income (Deduct)** Dividends received will be included in the partnership's accounting Net Income figure. These amounts will be allocated to partners as a separate source of income. This is discussed in more detail starting at Paragraph 18-57. Given this, dividends must be deducted in converting the partnership's accounting Net Income to the partnership's Net Business Income.

**Charitable Donations (Add Back)** These amounts are normally deducted in the determination of a partnership's accounting Net Income. In converting this figure to Net Business Income, these amounts will have to be added back.

Donations made by a partnership that otherwise qualify as charitable donations are flowed to the partners based on their partnership agreement. Corporations are

entitled to a deduction in arriving at Taxable Income, whereas individuals are entitled to a credit against Tax Payable. Donations, and the related credit or deduction, are only allocated to those partners who are partners on the last day of the partnership's year end.

**Political Contributions (Add Back)** As political contributions are normally subtracted in the determination of accounting Net Income, these amounts will have to be added back to arrive at the partnership's Net Business Income.

Qualifying political contributions are allocated to each partner as per the partnership agreement. Similar to charitable donations, the allocation of the contributions and the related credit is dependent on being a partner on the last day of the partnership's year in which the political contribution was made.

**Personal Expenditures (Add Back)** In some situations, a partnership may pay personal expenses of one or more partners. While these amounts may be deducted as an expense for accounting purposes, they are not deductible to the partnership in determining Net Business Income. To the extent that these amounts have been deducted in the determination of accounting Net Income, they will have to be added back in the determination of the partnership's Net Business Income.

**Business Transactions With Partners (No Adjustment)** While this may not be consistent with partnership law, administrative practice of the CRA does not restrict the ability of partners to enter into legitimate business transactions with their partnerships. Examples include loans made by partners to the partnership and the renting of a partner's property to the partnership. As long as the transactions are on regular commercial terms, such transactions will be treated for tax purposes in the same manner as transactions with persons who are not partners.

In general, such transactions will not require any adjustment of the accounting Net Income to arrive at the partnership's Net Business Income.

**Capital Cost Allowance** Any CCA that is deducted on partnership property must be deducted at the partnership level. As you would expect, the half-year rule, the AccII provisions, the available for use rules, the rental property restrictions, and other depreciable property rules are all applicable when determining the amount of CCA that a partnership may claim.

You should note that this requirement removes the possibility of different partners taking different amounts of CCA. If maximum CCA is deducted at the partnership level, all partners must, in effect, deduct maximum CCA.

It is not uncommon in partnership financial statements for the amortization figures to be based on the CCA amounts used for tax purposes. If this is the case, no net adjustment is required in converting accounting Net Income to the partnership's Net Business Income. However, the normal procedure, even when the amounts involved are the same, would be to add back the amortization figures used in the accounting statements, and deduct the appropriate CCA figure.

**Amounts Related To Dispositions Of Capital Assets** Accounting Net Income will include 100 percent of the accounting gains and losses on dispositions of depreciable and non-depreciable capital assets. These amounts must be added back (losses) or deducted (gains) in the determination of the partnership's Net Business Income.

As net taxable capital gains will be allocated to the partners as a separate source of income, these amounts are not included in the calculation of the partnership's Net Business Income. This is discussed in more detail starting at Paragraph 18-55.

As you will recall from Chapter 5, a disposition of a depreciable capital asset can also result in recapture of CCA or terminal losses. If recapture occurs, it will be added to accounting Net Income in order to arrive at the partnership's Net Business Income. Similarly, terminal losses will be deducted.

**Figure 18 - 2**
**Conversion - Partnership Accounting Income**
**To Partnership Net Business Income**

**Additions To Accounting Income:**
**- Specific To Partnerships**
- Salaries of partners
- Interest on capital accounts
- Drawings of partners (if deducted)
- Personal expenditures of partners (if deducted)

**- General Business (Additions)**
- Amortization, depreciation, and depletion of tangible and intangible assets (Accounting amounts)
- Recapture of CCA
- Tax reserves deducted in the prior year
- Losses on the disposition of capital assets (Accounting amounts)
- Charitable donations
- Political contributions
- Interest and penalties on income tax assessments
- Non-deductible automobile costs
- Fifty percent of business meals and entertainment expenses
- Club dues and cost of recreational facilities
- Non-deductible reserves (Accounting amounts)
- Fines, penalties, and illegal payments

**Deductions From Accounting Income:**
**- Specific To Partnerships**
- None

**- General Business (Deductions)**
- Capital cost allowances (CCA)
- Terminal losses
- Tax reserves claimed for the current year
- Gains on the disposition of capital assets (Accounting amounts)
- Deductible warranty expenditures
- Landscaping costs
- Dividends included in accounting income
- Other property income included in accounting income

**Reserves** The use of reserves is discussed in both Chapter 6 (e.g., reserve for bad debts) and Chapter 8 (e.g., capital gains reserve). These reserves are claimed by the partnership in exactly the same manner as partners, corporations, and trusts.

In general, the amounts involved in the application of reserve procedures are the same as the related amounts for accounting purposes. For example, the amount deducted for bad debts in the accounting statements is usually the same net amount that results from the application of reserve procedures in tax returns. However, the normal procedure here in determining the partnership's Net Business Income is to remove the accounting amounts and replace these amounts with the tax figures, even when the amounts are the same.

18-54. Figure 18-2 provides a list of the more common additions and deductions that arise in the process of converting the accounting income of a partnership into Net Business Income. You will note that many of the items presented here are the same as those presented in Figure 6-3 in Chapter 6 which covers business income.

## Capital Gains And Losses

18-55. In the preceding section, we noted the need to remove any accounting gains and losses on capital asset dispositions in the determination of Net Business Income. If dispositions created recapture of CCA or terminal losses, these amounts were added or deducted in the determination of Net Business Income. However, capital gains and losses were not included.

18-56. As you would expect, capital gain and losses are allocated to the members of the partnership to be included in their tax returns. Without going into great detail, once these amounts are allocated they are subject to the same rules that would apply if the gains and losses had resulted from dispositions by the partners themselves. One-half of the net gains will be included in Net Income For Tax Purposes. On some gains the lifetime capital gains deduction may be available and some losses may qualify as Business Investment Losses. If the partner is a private corporation, there will be an addition to the capital dividend account.

## Exercise Eighteen - 2

**Subject:** Partnership Net Business Income

The JL Partnership has two partners. Partner J, because he is actively managing the partnership, receives an annual salary of $45,000. Because Partner L has contributed most of the capital for the business, he receives an interest allocation of $22,000. The partnership agreement calls for the remaining profits, and all other allocations, to be split 60 percent to J and 40 percent to L. The salary and interest amounts are deducted in the determination of accounting Net Income and withdrawn by the partners during the year.

During the taxation year ending December 31, 2019, the partnership's accounting Net Income is $262,000. Other relevant information is as follows:

- The accountant deducted amortization charges of $26,000. Maximum CCA is $42,000.
- Accounting Net Income includes a deduction for charitable donations of $2,500.
- Accounting Net Income includes a gain on the sale of land of $24,000.

Determine the amounts of Net Business Income that will be allocated to Partner J and Partner L for the year ending December 31, 2019.

**SOLUTION available in print and online Study Guide.**

### *Dividend Income*

18-57. As we have noted in the preceding section, dividends received by a partnership are removed in the determination of the partnership's Net Business Income. When they are allocated to the members of the partnership to be included in their tax returns, they retain their character as eligible, non-eligible or capital dividends. Their treatment subsequent to allocation will depend on the type of taxpayer involved and/or the type of dividend received:

- Partners who are individuals must gross up the dividends by either 38 percent (for eligible dividends) or 15 percent (for non-eligible dividends). The dividends are then eligible for the usual dividend tax credits.
- Dividends allocated to corporate partners will not be grossed up. One hundred percent of the amount allocated will be included in Net Income For Tax Purposes. To the extent the dividends are from taxable Canadian corporations, they can be deducted in the determination of the corporation's Taxable Income.
- Capital dividends received by the partnership are allocated as capital dividends to both individual and corporate partners, generally retaining their tax-free nature.

### *Foreign Source Income*

18-58. Foreign source income received by a partnership will be allocated to the partners as either business or property income. As you would expect, the amounts that will be allocated to the partners will be the pre-withholding amounts that accrued to the partnership. That is, to the extent that foreign taxes were withheld, they will be added to the amount received for purposes of allocating this income to the members of the partnership. As the pre-withholding amounts are allocated to the partners, the *Income Tax Act* allows these partners to make use of any available foreign tax credits and/or foreign tax deductions (calculation of these credits and deductions is covered in Chapters 7 and 11).

## Exercise Eighteen - 3

**Subject:** Partnership Income Allocations

TThe ST Partnership has two partners who share all types of income on an equal basis. Partner S and T are both individuals. The Partnership's accounting Net Income for the year ending December 31, 2019 is $146,000. No salaries or interest payments to partners have been included in this calculation. However, the $146,000 includes $12,000 in eligible dividends, as well as a $31,000 gain on the sale of unused land. Amortization Expense deducted is equal to maximum CCA. Determine the amounts that will be included in the Net Income For Tax Purposes of Partner S and Partner T for the year ending December 31, 2019.

**SOLUTION available in print and online Study Guide.**

### *Allocations Of Related Tax Credits*

18-59. In the preceding sections, we have covered the various types of income that will be allocated to partners and the related tax credits. The type of income and expenditures that could give rise to tax credits can be summarized as follows:

- Dividend Income - tax credit is available if the partner is an individual.
- Charitable Donations - tax credit is available if the partner is an individual.
- Foreign Source Income - tax credit is available to all partners if foreign tax is withheld.
- Political Contributions - tax credit is available to all partners, but as covered in Chapter 4, the *Canada Elections Act* bans political contributions by corporations.

## Exercise Eighteen - 4

**Subject:** Allocations To Partners - Related Tax Credits

For the year ending December 31, 2019, the MN Partnership has correctly computed its Net Business Income to be $141,000. The partnership agreement calls for all allocations to Partner M and Partner N to be on a 50:50 basis. Partner M and N are both individuals and neither partner has Taxable Income that will be taxed federally at 33 percent. In determining the Net Business Income amount, the partnership's accountant added back $3,500 in charitable donations and $1,200 in contributions to a registered political party. In addition, $4,200 in eligible dividends received were deducted. The partners have made no charitable donations or political contributions as individuals. Determine the amount of any tax credits that the partnership will allocate to Partner M and Partner N for the year ending December 31, 2019.

**SOLUTION available in print and online Study Guide.**

## Methods Of Allocation

18-60. As we have seen in the preceding sections, income amounts must be allocated on a source-by-source basis. While a partnership agreement might simply state that all types of income will be allocated on the same basis, there is nothing to prevent different allocations for different sources. For example, business income could be allocated on an equal basis, with capital gains being allocated to one specific partner.

18-61. There are many ways in which the members of a partnership may agree to allocate income or loss. These allocations may be fixed, variable, or a combination of fixed and variable elements. Factors such as the value of services provided to the partnership (a salary component), capital contributions (an interest component), and amounts of risk assumed (personal assets at risk) may be taken into consideration. Alternatively, allocations may be

based upon fixed ratios determined by the partners or, in the absence of some other agreement, the equal fixed ratios that automatically apply under partnership law.

18-62. In general, the CRA will accept any income allocation agreement that is reasonable. It is possible, however, that the agreement could be constructed in a manner that would reduce or postpone taxes (e.g., an example of this would be the allocation of all partnership losses to partners with high levels of current income). In addition, an allocation could be used for income splitting purposes (e.g., allocation of large amounts of partnership income to a low-income spouse on a basis that is not consistent with his contribution of services or capital). In either of these circumstances, the CRA can apply ITA 103(1) or (1.1) to re-allocate the income on the basis that is reasonable in the circumstances.

**We suggest you work Self Study Problems Eighteen-3 and 4 at this point.**

# The Partnership Interest

## The Concept

18-63. A person who is a member of a partnership has the right to participate in profits and losses of the partnership and the right to an interest in partnership property, usually on the dissolution of the partnership. Such rights, collectively referred to as a partnership interest, constitute property for income tax purposes much in the same manner as a share of capital stock of a corporation.

18-64. A partnership interest is generally considered a non-depreciable capital property and, as a consequence, a disposition of a partnership interest will usually result in a capital gain or loss.

18-65. In many cases, a partnership interest is acquired when a partnership is formed. Each member of the new organization will acquire an interest, usually through the contribution of an amount of capital that is specified in the partnership agreement.

18-66. Alternatively, a partnership interest can be acquired from an existing partnership. This type of transaction can take two forms:

- The interest can be acquired directly from a current partner or partners by purchasing their interest.
- The interest can be acquired directly from the partnership by transferring assets to this organization.

## Acquiring A Partnership Interest

### *New Partnership*

18-67. For founding members of a new partnership, establishment of the adjusted cost base (ACB) of the partnership interest is very straightforward. For each of the partners, the ACB of their interest will simply be the fair value of the assets contributed to the partnership. If the contributions involve non-monetary assets, appraisals may be required. This, however, is a practical complication that does not alter the basic concept that is involved.

### *Admission To Existing Partnership*

18-68. From a technical point of view, partnership law provides that a partnership terminates on a change in the composition of the members (e.g., admissions or withdrawals of partners). In the discussion that follows, we assume that a partnership is not dissolved because of a change in its members. This assumption is consistent with the tax treatment of the partnership accounts. That is, tax law does not require the admission or withdrawal of a partner to be treated as a termination of the partnership, followed by the formation of a new partnership.

18-69. In those cases where a partnership interest is purchased directly from an existing partner, the procedures are very straightforward. If a person becomes a partner by acquiring

another partner's interest, then cost will equal the purchase price. For example, if Mr. Davis acquires the one-third interest of Mr. Allan for $90,000, then both the cost to Mr. Davis and the proceeds of disposition to Mr. Allan would be $90,000.

18-70. The situation becomes more complex when the partnership interest is acquired through direct payments to more than one partner.

**EXAMPLE** An existing partnership has three equal partners, each of whom has made a capital contribution of $16,000. They would like to bring in a new equal partner, with each partner then having a 25 percent interest in the organization. The new partner, Mr. Zheng agrees to pay $30,000 to each of the existing partners for one-quarter of their one-third interest. Note that by selling one-quarter of their one-third interest, each partner retains a 25 percent interest [(75%)(1/3) = 25%].

**ANALYSIS** Mr. Zheng would have an ACB of $90,000, the consideration given up for the 25 percent interest.

Each of the original partners would have a capital gain calculated as follows:

| | |
|---|---|
| Proceeds Of Disposition To Each Partner | $30,000 |
| ACB of Part Interest [(25%)($16,000)] | ( 4,000) |
| Capital Gain For Each Partner | $26,000 |

18-71. The capital accounts in the accounting records of the partnership and the partners' ACB will be as follows:

| | Partner 1 | Partner 2 | Partner 3 | Mr. Zheng |
|---|---|---|---|---|
| Capital Before Admitting Zheng | $16,000 | $16,000 | $16,000 | Nil |
| Adjustment For Admission Of Zheng | ( 4,000) | ( 4,000) | ( 4,000) | $12,000 |
| Ending Capital Accounts | $12,000 | $12,000 | $12,000 | $12,000 |
| ACB Of Partnership Interest | $12,000 | $12,000 | $12,000 | $90,000 |

18-72. Note that, while the accounting values for the interests of the original three partners are equal to their ACBs, this is not the case for Mr. Zheng. In contrast to his accounting value of $12,000, his ACB would be his cost of $90,000 [(3)($30,000)].

18-73. To this point, we have only considered situations where assets were given to specific partners in return for the new partner's acquired interest. There are also situations in which the new partner makes a payment directly to the partnership in return for his interest.

18-74. Returning to the example in Paragraph 18-70, if Mr. Zheng had paid the $90,000 directly to the partnership, there would be no tax consequences for the existing partners. No disposition of any part of their interest would have occurred and, as a consequence, no capital gain would be recorded and the ACBs of their interests would remain at $16,000. Mr. Zheng's interest would be recorded at $90,000 for both tax and accounting purposes.

## Exercise Eighteen - 5

**Subject:** Admission Of A Partner

Alan and Balan are equal partners in the Alban Partnership. On September 1, 2019, Alan and Balan's partnership capital account balances are $48,000 each. This is also equal to the adjusted cost base of their interests. As the result of paying $40,000 to each of Alan and Balan, Caitlan is admitted as an equal partner (1/3 interest) on September 1, 2019. Calculate the tax effects of the partner admission for Alan and Balan. In addition, determine the accounting balances for each of the partner's

capital accounts after the admission of Caitlan, as well as the adjusted cost base for each partner after the admission of Caitlan.

**SOLUTION available in print and online Study Guide.**

## Adjusted Cost Base Of The Partnership Interest

### *Basic Concept*

18-75. As we have noted, a partnership interest is viewed in tax legislation as a non-depreciable capital asset. A discussed in Chapter 8, the adjusted cost base (ACB) of a capital property is defined in ITA 54 as its cost, plus or minus the adjustments in ITA 53.

18-76. In the preceding section, we illustrated how the ACB of a partnership interest would be determined at the time a partnership interest is acquired.

18-77. Subsequent to its acquisition, the partnership interest is determined by starting with the ACB of the preceding year and adjusting it for various items. The most common adjustments are for:

- current year income allocations;
- current year Drawings; and
- current year capital contributions.

18-78. There are, however, many other possible adjustments and most of these will be covered in this section. It is important to note the importance of making these adjustments. If these adjustments were not required, any gain or loss on a subsequent sale of the partnership interest would result in these amounts becoming part of the gain or loss on the sale.

> **EXAMPLE** John Port acquires his partnership interest for \$100,000. At a later point in time, he makes an additional capital contribution of \$20,000. Subsequent to making this additional contribution, he sells his interest for \$150,000.
>
> **ANALYSIS** As we shall note in the material which follows, John will add the \$20,000 capital contribution to his adjusted cost base, resulting in a new value of \$120,000 (\$100,000 + \$20,000). Given this, the capital gain on the disposition of the interest will be \$30,000 (\$150,000 - \$120,000). If he had not made the required adjustment, the gain would have been \$50,000 (\$150,000 - \$100,000).

### *Timing Of Adjustments*

18-79. Before proceeding to a discussion of the more common adjustments to the cost base of a partnership interest, some attention must be given to the timing of these adjustments. With respect to capital contributions and drawings, the timing is very straightforward. These adjustments are made at the time of the contribution or drawing.

18-80. In contrast, those adjustments related to allocations of income or tax credits are not made during the period in which the income or tax credit arises. Rather, these adjustments to the ACB of a partnership interest are made on the first day of the following fiscal period. These procedures will be illustrated in the material that follows.

### *Adjustments For Partnership Income Components*

18-81. It would be unusual, in any given year, for the adjusted cost base of a partnership interest not to be adjusted for partnership income allocations. As this must be added on a source-by-source basis, specific sources are given separate consideration here:

> **Net Business Income** As discussed in our section on partnership income determination, accounting Net Income must be converted to the partnership's Net Business Income. This amount is allocated to each partner on the basis of the partnership agreement. The amounts so determined will be added (Net Business Income) or subtracted (Net Business Loss) to the adjusted cost base of each partner. As noted, this increase or decrease does not occur until the first day of the following fiscal period.

**EXAMPLE** Tom and Theresa begin the Double T partnership in January, 2019 and select December 31 as their year end. They each contribute $1,000 to Double T. During 2019, the partnership earns $21,000 in gross service revenue. The only expenses incurred are $6,000 in business meals and entertainment.

**ANALYSIS** Accounting Net Income for the partnership would be $15,000 ($21,000 - $6,000). However, Net Business Income would be $18,000, the $15,000 of accounting Net Income, plus $3,000, the non-deductible one-half of the expenses for business meals and entertainment. This means that each partner would be allocated $9,000 [(1/2)($18,000)] in business income, and each partnership interest would be increased by the same amount. While the income amounts would be included in the partners' 2019 tax return, the addition to the adjusted cost base would not be made until January 1, 2020.

**Capital Gains And Losses** As discussed previously, these amounts will be allocated to the partners on the basis of the partnership agreement. Once these amounts are allocated, the taxable or allowable amounts (one-half) will be included in the partner's tax returns.

Despite the fact that only one-half of these amounts will be taxable or deductible, the adjustment to the ACB of the partnership interest is for the full amount and occurs on the first day of the following fiscal period. This inclusion of the full amount provides for the non-taxable one-half of the gain to be recovered on a tax free basis if the partnership interest is sold.

**EXAMPLE** Weekday Partnership has four equal partners and a December 31 year end. Each partner contributed $1,950 when the partnership began on May 1, 2019. Weekday used the initial contributions of $7,800 to acquire two parcels of land. Both parcels were capital property and were sold in December, 2019. The sale of parcel A resulted in a capital gain of $5,300 and the sale of parcel B resulted in a capital loss of $700. There were no other transactions during the fiscal year.

**ANALYSIS** The total capital gain for each partner is $1,150 [(1/4)($5,300 – $700)]. The allocation to each partner's Net Income For Tax Purposes will be the taxable amount of $575 [(1/2)($1,150)]. However, the allocation to the partnership interest will be, as shown in the following table, the full amount of the partner's share of the capital gain.

The ACB of each partnership interest is calculated as follows:

| | | |
|---|---|---|
| ACB - May 1, 2019 to December 31, 2019 | | $1,950 |
| Net Capital Gain Allocated: | | |
| Capital Gain [(1/4)($5,300)] | $1,325 | |
| Capital Loss [(1/4)($700)] | ( 175) | 1,150 |
| ACB Of Partnership Interest - January 1, 2020 | | $3,100 |

**Dividends** As previously discussed, taxable dividends earned by a partnership retain their character (i.e., eligible, non-eligible or capital) when they are allocated to the partners. In calculating the ACB of a partnership interest, a partner's share of both capital and taxable dividends is added to the ACB of his partnership interest on the first day of the following fiscal period.

**EXAMPLE** Fred and Barney are equal partners in Stone-Works Partnership that began operations January 1, 2019. A December 31 year end was selected. Each partner initially contributed $5,000. The only income received by the partnership was $13,000 of eligible dividends, and $4,200 of capital dividends. No amounts were withdrawn from the partnership in 2019.

**ANALYSIS** Each partner is required to include one-half of the taxable dividends of $13,000, plus an additional 38 percent gross-up, in his 2019 Net Income For

Tax Purposes. This amounts to income of $8,970 [(50%)($13,000)(138%)]. In conjunction with this allocation, each partner would be eligible for a federal dividend tax credit of $1,347 [(50%)($13,000)(38%)(6/11)]. The capital dividends are not included in each partner's income as they are tax free. The ACB of Fred and Barney's interest would be as follows:

| | |
|---|---|
| ACB - January 1, 2019 to December 31, 2019 | $ 5,000 |
| Allocation Of Dividends Subject To Tax [(50%)($13,000)] | 6,500 |
| Allocation Of Capital Dividends [(50%)($4,200)] | 2,100 |
| ACB Of Partnership Interest - January 1, 2020 | $13,600 |

Two things should be noted in this calculation. First, for purposes of calculating the ACB of the partnership interests, no gross up is added to the dividends subject to tax. Second, the dividends are not added to the ACB until the first day of the year following their allocation to the partners.

### Adjustments For Capital Contributions And Drawings

18-82. These adjustments require little in the way of explanation:

- Net capital contributions are added to the adjusted cost base of the partner's interest.
- Drawings reduce the adjusted cost base of the partnership interest.

Note that bona fide loans by a partner to the partnership are not considered capital contributions. Similarly, loans from the partnership to a partner are not considered to be drawings.

**EXAMPLE** The ACB of Mr. Allan's partnership interest is $20,450 at January 1, 2019. In March, 2019, he contributes $8,200 to the partnership as a capital contribution and makes withdrawals of $2,000 in each of May, August, and November, 2019.

**ANALYSIS** The ACB of Mr. Allan's partnership interest is calculated as follows:

| | |
|---|---|
| ACB – January 1, 2019 | $20,450 |
| Capital Contributions – March 2019 | 8,200 |
| Drawings – May, August And November 2019 [($2,000)(3)] | ( 6,000) |
| ACB – December 31, 2019 | $22,650 |

### Charitable Donations and Political Contributions

18-83. Amounts donated or political contributions made by a partnership in a particular year are considered donated or contributed by each partner in proportion to that partner's profit sharing ratio. As it is the partners who enjoy the benefits of making the contributions (i.e., the deductions or tax credits), such amounts reduce the ACB of a partnership interest. Note, however, this adjustment does not occur until the first day of the following fiscal period.

**EXAMPLE** During the taxation year ending December 31, 2019, a partnership donated $7,500 to charitable organizations. The three partners, who are all individuals, each have a one-third interest in profits. All donations are eligible for the charitable donations tax credit.

**ANALYSIS** Each of the three partners would be entitled to allocations of $2,500 towards the calculation of their individual charitable donations tax credit for 2019. As a consequence of this allocation, the ACB of each of their partnership interests would be reduced by $2,500. As we have noted, this reduction does not occur until January 1, 2020.

### Negative ACB

18-84. In general, if negative adjustments to the ACB of a capital asset exceed its cost plus any positive adjustments to the ACB, the excess must be taken into income under ITA 40(3) as

a capital gain. While technically an ACB can only be positive or nil, it is common to refer to assets that have experienced such adjustments as having a negative adjusted cost base.

18-85. This creates a problem for partnership interests in that withdrawals are deducted from the ACB of the partnership interest in the year they occur, while income allocations are only recorded on the first day of the following year. As partners usually withdraw their anticipated income allocations during the year in which they accrue, negative ACBs for partnership interests would not be unusual.

18-86. Because of this problem, the *Income Tax Act* allows general partners to carry forward a negative ACB, without taking the capital gain into income. This deferral is applicable until the partner disposes of his interest, either through a sale or as the result of a deemed disposition at death.

> **EXAMPLE** During 2019, in anticipation of the 2019 allocation of partnership income, a partner draws $42,000 from the partnership. For 2019, his share of partnership income is $45,000. On January 1, 2019, his partnership interest has an ACB of $25,000.
>
> **ANALYSIS** On December 31, 2019, the ACB of this partnership interest would be nil and there would be an excess of drawings over the January 1, 2019 ACB of $17,000 ($25,000 - $42,000). In the absence of a special provision for partnership interests, $8,500 [(1/2)($17,000)] would have to be taken into the partner's income as a taxable capital gain. However, because of the special provision applicable to partnership interests, this will not be the case. Note that, on January 1, 2020, the ACB of this interest would be $28,000 ($25,000 - $42,000 + $45,000).

18-87. When the disposition results from a deemed disposition at death, there are rollover provisions that allow a continued carry forward of the negative ACB when the partnership interest is bequeathed to a spouse or common-law partner, or a trust in favour of a spouse or common-law partner.

18-88. Note that the preceding rules only apply to active general partners. In the case of limited partners (see Paragraph 18-91) or general partners who are not active in the partnership, the deferral of the gain that is implicit in carrying forward a negative ACB is not available. Such amounts must be taken into income in the year in which they occur.

## Exercise Eighteen - 6

**Subject:** ACB Of Partnership Interest

On January 1, 2019 Raymond and Robert form the RR Partnership. The partnership has a December 31 year end. The partnership agreement provides Robert with a 40 percent share of profits and losses. Robert initially contributes $12,500 and makes a further contribution of $7,200 on June 10, 2019. He withdraws $4,000 on October 31, 2019. RR Partnership has the following sources of income for 2019:

| | |
|---|---:|
| Capital Gain On Corporate Shares | $11,600 |
| Eligible Dividends Received From Canadian Corporations | 3,100 |
| Net Business Income | 46,700 |

Determine the ACB of Robert's partnership interest on December 31, 2019, and at January 1, 2020. In addition, determine the amount that would be included in Robert's 2019 Net Income For Tax Purposes as a consequence of his interest in the RR Partnership.

**SOLUTION available in print and online Study Guide.**

## Disposition Of A Partnership Interest

### *Sale To An Arm's Length Party*

18-89. If a partnership interest is sold to an arm's length party, the tax effects are very straightforward. The adjusted cost base of the partnership interest is subtracted from the proceeds resulting from its sale. If the result is positive, it is a capital gain, one-half of which will be taxed in the hands of the partner. Alternatively, if the result is negative, one-half of this amount will be an allowable capital loss which can be deducted by the partner to the extent of his current year taxable capital gains. Any unused amount can be carried over to previous and subsequent years.

### *Withdrawal From Partnership*

18-90. When a partner withdraws from a partnership, he is essentially disposing of his interest in that partnership. While this could involve using partnership assets to buy out the partner, the more normal procedure is to have one or more of the other partners purchase the interest of the withdrawing partner.

> **EXAMPLE** The QST Partnership has three partners who share all income amounts on an equal basis. The ACB of their partnership interests are as follows:
>
> | | |
> |---|---:|
> | Partner Q | $250,000 |
> | Partner S | 250,000 |
> | Partner T | 250,000 |
>
> Partner T has decided to retire and will withdraw from the partnership. In return for his interest, each of the remaining partners will pay him $175,000.
>
> **ANALYSIS** Partner T will have a taxable capital gain of $50,000 [(1/2)($175,000 + $175,000 - $250,000)]. There will no immediate tax consequences to partners Q and S. However, the ACB of each of their interests will be increased to $425,000, the original $250,000, plus the additional investment of $175,000.
>
> You might wish to note that, assuming the assets of the partnership are not revalued, the accounting values for the interests of each of the remaining partners will be $375,000 [$250,000 + (1/2)($250,000)].

**We suggest you work Self Study Problems Eighteen-5 and 6 at this point.**

# Limited Partnerships And Limited Partners

## Definitions

### *Limited Partner*

18-91. A limited partnership is one that has at least one limited partner and one general partner. As defined in most provincial legislation, a limited partner is one whose liability for the debts of the Partnership is limited to the amount of his contribution to the Partnership, and who is not permitted to participate in the management of the Partnership. A partner whose liability is limited under partnership law is considered a limited partner for income tax purposes.

18-92. While the term "limited partner" generally refers to a partner who is relieved of general responsibility for amounts in excess of his capital contribution, the definition also includes partners whose liability is limited by the presence of specific contractual arrangements. Examples of this type of situation include:

- guarantees that someone will acquire their partnership interest regardless of its value;
- provisions indicating that amounts a partner has agreed to contribute to the partnership may never have to be paid; and
- provisions that guarantee the partner that he will be reimbursed for any partnership losses, usually by the general partner.

18-93. Note that members of a limited liability partnership (see Paragraph 18-22) do not fall within the definition of a limited partner. They have limited responsibility for certain types of liabilities (e.g., liabilities arising as the result of negligent action by their professional partners). However, they continue to have unlimited liability for other partnership obligations.

## At-Risk Rules

### Basic Concept

18-94. Historically, limited partnership structures have been used to fund high-risk ventures that benefit from generous income tax incentives. These structures have been used with Canadian films, Canadian mining and exploration operations, scientific research and experimental development, real estate, and construction.

18-95. General partners entice investors with limited liability protection, combined with the advantages of significant flow through of deductible losses and other tax incentives. The general partners usually do not share in the deductions, receiving their compensation through fees that are charged to the limited partners for managing the partnership.

18-96. The at-risk rules were introduced in order to restrict the ability of certain investors in partnerships, typically limited partners, to receive tax deductions or tax credits in excess of the amount that they stand to lose on their investment. In simplified terms, the at-risk rules work to ensure that $30,000 of tax deductions are not available to a limited partner who has less than $30,000 at risk.

### The At-Risk Amount

18-97. The at-risk amount sets the annual limit on the amount of tax preferences and incentives that may flow through to limited partners. Specifically, the *Income Tax Act* provides restrictions on the allocation to limited partners of scientific research and experimental development credits, resource expenditures, investment tax credits, non-farming business losses, and property losses. Under ITA 96(2.2), the at-risk amount is calculated at the end of a partnership's fiscal period as follows:

| | | |
|---|---|---|
| ACB Of The Partnership Interest | | $xxx |
| Share Of Partnership Income (But Not Losses) For The Current Period (Current Year Income Allocation For ACB Purposes - See Paragraph 18-98) | | xxx |
| Subtotal | | $xxx |
| Less: | | |
| Amounts Owed To The Partnership | ($xxx) | |
| Other Amounts Intended To Reduce The Investment Risk | ( xxx) | ( xxx) |
| At-Risk Amount | | $xxx |

18-98. The addition of the share of partnership income (not losses) is intended to ensure that current year income allocations, which will not be added to the ACB of the partnership interest until the following fiscal year, are taken into consideration at the end of the current year. The amount that is added here is the same income allocation that will be added to the ACB. That is, it does not include the dividend gross up, nor is it adjusted downwards for the non-taxable portion of capital gains.

18-99. The at-risk amount is reduced by two amounts. The first represents the outstanding balance of any amount owing by the partner to the partnership for the acquisition of the partnership interest. This amount is subtracted as it is included in the partnership interest but, prior to its actual payment, it is not really at risk.

18-100. The second amount relates to financial incentives designed to reduce the investment risk or exposure to the limited partner. An example of this would be a promise by the general partner to acquire the partnership interest at an amount in excess of the value of the partnership interest at the option of the limited partner.

### Limited Partnership Losses

18-101. The at-risk rules limit the ability of a limited partner to utilize certain types of losses. The rules do not directly affect farm losses and capital losses since these losses carry their own restrictions. Farm losses during the current year may be limited by the restricted farm loss rules and, in addition, any carry over of such restricted farm losses can only be applied against farming income (see Chapter 6). Similarly, current year allowable capital losses are only deductible to the extent of current year taxable capital gains.

18-102. ITA 96(2.1) indicates that a partner's share of losses, other than those associated with farming or the disposition of capital assets, can be deducted to the extent of the at-risk amount. The excess is referred to as the "limited partnership loss". It is a carry forward balance that can be carried forward indefinitely and can only be claimed against future income from the partnership or increases of the at-risk amount from that same partnership. There is no carry back of limited partnership losses.

**EXAMPLE** On January 1, 2019, Jenny Johnson acquires a 10 percent limited partnership interest in Tax-Time, a partnership that provides tax preparation services. This interest cost her $15,000, with $6,000 paid in cash and the balance of $9,000 payable in 36 months, without interest. At December 31, 2019, Tax-Time determines that it has a $22,000 capital gain and an $111,000 business loss. Jenny is allocated 10 percent of these amounts.

**ANALYSIS** As a 10 percent limited partner, Jenny is allocated a portion of the business loss equal to $11,100. However, her at-risk amount restricts the business loss that Jenny may be able to use. The at-risk amount is calculated as follows:

| | | |
|---|---|---|
| ACB Of The Partnership Interest | | $15,000 |
| Share Of Partnership Income [(10%)($22,000 Capital Gain)] | | 2,200 |
| Subtotal | | $17,200 |
| Less: | | |
| Amounts Owed To The Partnership | ($9,000) | |
| Other Amounts Intended To Reduce The Investment Risk | Nil | ( 9,000) |
| At-Risk Amount – December 31, 2019 | | $ 8,200 |

For 2019, Jenny will be able to deduct her share of the total partnership loss to the extent of her $8,200 at-risk amount. This will leave a non-deductible limited partnership loss for 2019 of $2,900 ($11,100 - $8,200). In general, Jenny will be able to use the limited partnership loss in 2020 or subsequent years if her at-risk amount increases. This may occur if she makes additional contributions, is allocated additional income from the partnership in 2020, or pays the amount owed to the partnership. It should also be noted that there are special adjustments to the ACB of a limited partner's partnership interest that are beyond the scope of this material.

## Exercise Eighteen - 7

**Subject:** Limited Partnership Loss

During 2019, Stuart Jones acquires an interest in a limited partnership for $200,000. An initial $50,000 is paid immediately, with the $150,000 balance payable in eight years. The general partner has agreed to acquire Stuart's interest at any subsequent date, returning his $50,000 payment and assuming responsibility for the $150,000 payable. For 2019, the limited partnership has allocated losses of $75,000 to Stuart. How much of this loss is Stuart entitled to claim as a deduction on his 2019 tax return? Indicate the amount of his limited partnership loss at the end of 2019.

**SOLUTION available in print and online Study Guide.**

**We suggest you work Self Study Problem Eighteen-7 at this point.**

# Transfer Of Property To And From A Partnership

## Definition Of Canadian Partnership

18-103. Since the ITA treats partners as distinct from the partnership, transferring property between the partners and the partnership may have income tax consequences. Such consequences are generally dependent on the purpose of the property transfer and whether the underlying partnership meets the ITA 102 definition of a "Canadian partnership":

> **ITA 102** In this subdivision, "Canadian partnership" means a partnership all of the members of which were, at any time in respect of which the expression is relevant, resident in Canada.

18-104. Whether the partnership is a general, limited, or limited liability partnership is irrelevant to the determination of its status as a Canadian partnership. In addition, the definition does not require that the partnership be formed in Canada. For example, a U.S. based partnership with all Canadian resident members would qualify.

18-105. If the required conditions are met, the *Income Tax Act* contains rollover provisions that provide for tax deferral on such transactions. However, where the conditions are not met, the transfers will be taxed as a disposition/acquisition at fair market value.

18-106. In covering this material on property transfers, we will first look at the rules applicable to transfers of property to and from a partnership when a rollover provision is not used. This will be followed by a discussion of some of the more commonly used partnership rollover provisions.

## Transfers With No Rollover Provision

### *Transfers From Partners To The Partnership*

18-107. If a person transfers property to a partnership of which he is member, or to a partnership of which he becomes a member as a result of the transfer, ITA 97(1) deems the person to have disposed of the property at fair market value and the partnership to have acquired the property at the same amount.

18-108. In general, the fair market value of the transferred asset is added to the ACB of the transferor's partnership interest. However, this addition would be reduced by any consideration given to the contributor because of his contribution. This rule is applicable without regard to whether the partnership qualifies as a Canadian partnership.

> **EXAMPLE** Diane Jefferson is a member of CG Partnership. She is required to make an additional 2019 capital contribution to the partnership and decides to make the contribution by transferring investments that she had purchased for $10,000. At the time of the transfer, they have a fair market value of $24,000.

> **ANALYSIS** Diane will be considered to have disposed of the investments for $24,000. This will result in a $7,000 [(1/2)($24,000 - $10,000)] taxable capital gain for 2019. Diane will also be considered to have made a $24,000 capital contribution that will increase the ACB of her partnership interest by the same amount. The partnership will be considered to have acquired the investments from Diane for $24,000.

## Exercise Eighteen - 8

**Subject:** Transfers From Partner To Partnership (No Rollover)

Charles Woodward is one of four equal partners in LIU Partnership (LIU). During the current year, Charles contributes a tract of land to the partnership. Charles does not use a rollover provision to make the transfer. Charles acquired the land for $33,000 and, at the time of transfer, it is valued at $100,000. Describe the tax consequences to Charles and LIU in the following three situations:

A. No consideration is received from LIU.
B. Charles receives $25,000 in cash from LIU on the transfer.
C. Charles receives $112,000 in cash from LIU on the transfer.

**SOLUTION available in print and online Study Guide.**

### *Transfers From The Partnership To Partners*

18-109. If a partnership transfers property to a partner, ITA 98(2) deems the partnership to have disposed of the property at fair market value and the partner to have acquired the property at the same amount. There is no requirement that the partner remains a partner after the transfer and the rule is applicable without regard to whether the partnership qualifies as a Canadian partnership. This provision is typically used when a partnership is dissolved, or when partial distributions of partnership property are made in an ongoing partnership.

**EXAMPLE** Bill Davis is a 40 percent partner in the FV Partnership. The partnership owns a piece of land that has an ACB of $2,900 and transfers it to Bill in June, 2019 for no consideration. The land has a fair market value of $10,000 at this time.

**ANALYSIS** The partnership is considered to have disposed of the land for its fair market value of $10,000, resulting in a capital gain of $7,100 ($10,000 - $2,900). Bill's share of this gain is $2,840 [(40%)($7,100)]. This amount will be allocated to Bill and, as a consequence, he will report a taxable capital gain of $1,420 [(1/2)($2,840)] in his 2019 tax return. Bill will also be considered to have acquired the land for $10,000 and to have made a withdrawal from the partnership of $10,000. The ACB of his partnership interest will be reduced by the $10,000 withdrawal and increased by the $2,840 allocation of the capital gain.

## Exercise Eighteen - 9

**Subject:** Transfers From Partnership To Partners

Darlene is one of five equal partners in the DG Partnership. During the taxation year ending December 31, 2019, DG distributes some of its investments to each of the partners. The distributed investments have an adjusted cost base of $39,000 and, at the time of transfer, they have a fair market value of $94,000. Darlene receives one-fifth of these investments. At the time of this transfer, the adjusted cost base of Darlene's partnership interest is $30,000. What are the tax consequences to DG and Darlene with respect to this distribution? Your answer should include Darlene's adjusted cost base for the investments and the amount of her partnership interest on both December 31, 2019, and on January 1, 2020.

**SOLUTION available in print and online Study Guide.**

## Common Partnership Rollovers

### Transfers From Partners To The Partnership

18-110. If a person transfers property to a Canadian partnership and all members of that partnership jointly elect, then property transferred to the partnership may be transferred on a rollover basis. This means that the property can be transferred at elected values (usually tax values), rather than at the fair market values that must be used in the absence of a rollover provision. This rule applies both to persons who are existing partners, as well as to persons who become partners by contributing property to the partnership.

18-111. ITA 97(2) indicates that, for this type of transfer, the ITA 85(1) rules apply. The ITA 85(1) rules are generally applicable to transfers of property to a corporation and are discussed in detail in Chapter 16. There are, however, some differences in the application of these rules when the transfer is to a partnership. The more notable of these differences are as follows:

- Real property inventory can be transferred to a partnership, but not to a corporation.
- When a transferor takes back consideration with a value less than that of the property transferred to a corporation, it may involve a gift to a related party. In the case of transfers to a partnership, the gift portion is added to the ACB of the partnership interest. As discussed in Chapter 16, if such a transfer was made to a corporation, it would usually result in double taxation of the gifted amount.
- When a transferor receives consideration in excess of the value of the property transferred to a corporation, the excess is subject to taxation. When this happens in conjunction with a transfer of property to a partnership, the excess is generally viewed as a drawing and is not subject to taxation.

18-112. Differences between the elected amounts and consideration other than a partnership interest affect the ACB of the partnership interest.

**EXAMPLE** Janice Donovan will join the On-Off Partnership that provides interior lighting products. She plans to make an initial capital contribution of a parcel of land with an ACB of $100,000 and a fair market value of $250,000. She wishes to transfer the land at an elected value of $160,000. The existing members agree and file a joint election authorizing the transaction for $160,000. Janice has a choice between three different packages of consideration:

A. No cash.
B. Cash of $100,000.
C. Cash of $160,000.

**ANALYSIS** ITA 97(2) uses the transfer limits described within ITA 85. The basic acceptable transfer range is from the land's ACB of $100,000 to its fair market value of $250,000. While not applicable in this case, the elected value is also limited to the amount of non-partnership interest consideration received. The relevant values for the three Cases are as follows:

| Case | ACB Of Partnership Interest | Capital Gain |
|---|---:|---:|
| No Cash | $160,000 | $60,000 |
| Cash Of $100,000 | $ 60,000 | 60,000 |
| Cash Of $160,000 | Nil | 60,000 |

## Exercise Eighteen - 10

**Subject:** Transfers From Partner To Partnership (With Rollover)

Samantha Floren is one of three equal partners in the SFL Partnership. During the current year, Samantha transfers land to the partnership as a capital contribution. She had acquired the land several years ago for $156,000. At the time of transfer, it is valued at $263,000. She would like to use any available rollover provision in order to minimize her current taxes. Assuming the appropriate rollover provision is used, what are the tax consequences of this transfer?

**SOLUTION available in print and online Study Guide.**

### Partnership Property Transferred To A New Partnership

18-113. A partnership may be dissolved in a number of situations. Included would be the addition or retirement of partners in cases where the partnership agreement does not provide for the continuation of the partnership. The dissolution of a partnership is considered to be a disposition of partnership property and, in the absence of a rollover provision, would result in tax consequences to the partners. However, this treatment can be avoided if the partnership property is transferred to a new partnership.

18-114. ITA 98(6) provides automatic (i.e., no election is required) rollover treatment where all of the property of a Canadian partnership that has ceased to exist is transferred to a new Canadian partnership. A further condition is that all of the members of the new partnership must have been members of the old partnership.

18-115. While many rollover provisions provide tax free treatment by providing for a deemed disposition at the tax cost of the property, ITA 98(6) takes a different approach. This Subsection deems the old and new partnerships to be the same entity, with the result being that there is no disposition of the property and no tax consequences to the transferor. This means that the ITA 98(6) rollover involves fewer complications than would be found in most rollover applications.

18-116. It is important to note that, while all of the members of the new partnership have to have been members of the old partnership, not all of the members of the old partnership have to become members of the new partnership. This rollover is typically used when a partner retires.

18-117. The retirement of a partner usually involves distributing some of the partnership property to the retiring partner. This makes it impossible to fully comply with the requirement of ITA 98(6) that all of the property of the old partnership be transferred. This problem was resolved by IT-338R2, "Partnership Interests - Effects On Adjusted Cost Base Resulting From The Admission Or Retirement Of A Partner", which states that all of the property of the old partnership is considered to mean all the property after the settlement of a retired partner's interest. While IT-338R2 has been cancelled, it appears that the CRA continues to maintain this position.

### Partnership Property Transferred To A Sole Proprietorship

18-118. This rollover, provided for in ITA 98(5) applies automatically where a Canadian partnership ceases to exist and, within three months of the cessation date, one of the partners continues to carry on the partnership business as a sole proprietor. This rollover treatment is provided for partnership property distributed to the proprietor and, in general, ensures that there are no tax consequences associated with the disposition of that proprietor's partnership interest.

18-119. There is an exception in situations where the tax cost of partnership property received by the proprietor exceeds the ACB of his or her partnership interest. In this case, there will be a capital gain. Alternatively, if the ACB of the proprietor's partnership interest

exceeds the tax cost of partnership property received by the proprietor, the rules allow the tax cost of non-depreciable partnership property to be increased to reflect this difference. You might wish to note that this is similar to the bump that is available in amalgamations and subsidiary wind ups (see Chapter 17)

18-120. This rollover typically applies where one of the partners in a two-person partnership retires or dies, leaving the remaining person to continue the business. As a partnership must have at least two partners, there is no possibility of the partnership continuing. Note, however, that the rollover only applies to the partner who continues the business. A retiring partner will have a disposition at fair market value with the usual tax consequences associated with such a disposition.

## Partnership Property Transferred To A Corporation

18-121. The decision to convert a partnership to a corporation, or to incorporate a partnership, generally arises when a partnership that has realized losses in its initial years becomes profitable. Prior to that time, the partnership form is useful as it allows the partners to use the partnership losses to offset their income from other sources. Once the partnership has become profitable, corporate status may be preferred because of the availability of the small business deduction, the possibility of deferring taxes on income retained within the corporation, or the desire to split income with other related persons.

18-122. The process of incorporating a partnership on a tax deferred basis generally requires two rollovers, ITA 85(2) and ITA 85(3). Under ITA 85(2), eligible partnership property is transferred to a taxable Canadian corporation for either shares or a combination of shares and other consideration. The transfer takes place at elected values which can include the tax cost of the property, thereby avoiding tax consequences to the partnership. This rollover treatment is only available if the corporation and all the partners jointly elect rollover treatment.

18-123. At this point, the partnership is holding shares in the corporation and the partners are continuing to hold their partnership interests. ITA 85(3) then provides for a transfer at tax values of the partnership's holding of the corporation's shares to the partners in return for their partnership interests. This is accompanied by a wind-up of the partnership.

18-124. If the following conditions are met, the ITA 85(3) rollover treatment is automatic, with no election required:

- The partnership must have disposed of property to a taxable Canadian corporation under ITA 85(2).
- The partnership must be wound up within 60 days of the disposition of its property to the corporation.
- Immediately before the partnership is wound up, the only property it holds is money or property received from the corporation as a result of the application of ITA 85(2).

18-125. The winding-up of a partnership usually requires the distribution of all partnership property, the settlement of partnership obligations, as well as certain provincial formalities such as de-registration.

18-126. These rules are designed to provide a tax free means of incorporating a partnership. However, tax consequences may arise in two particular instances. First, ITA 85(2) only applies to "eligible property" as defined in ITA 85(1.1). The major item that would not be included in this definition would be an inventory of real property (i.e., real property held for sale rather than use). If such non-eligible property is transferred from a partnership to a corporation, the transfer will be at fair market value, resulting in the usual tax consequences.

18-127. A second situation in which the incorporation of a partnership may result in tax consequences would arise when a partner receives consideration in excess of the ACB of his partnership interest. While this may result in a capital gain, it can be avoided with the proper use of the ITA 85(3) rollover provision.

**EXAMPLE** Danielle and Christine are equal partners in the Flag Partnership. The recent success of the business has led to a decision to incorporate. The only asset Flag owns is an inventory of flags that cost $50,000, but is currently worth $200,000. The ACB of each partner's partnership interest is $34,000. The corporation will issue only common shares as consideration for the acquisition of the flag inventory.

**ANALYSIS** Danielle, Christine, and the corporation will jointly elect to transfer the inventory from the Flag Partnership at its tax cost of $50,000. Flag will be deemed to have disposed of the inventory for $50,000 and the corporation will be considered to have acquired the inventory for $50,000. No tax consequences will arise on the disposition. Flag Partnership will receive common shares of the corporation that will have an ACB and PUC of $50,000. At this point, Flag Partnership owns shares of the corporation and the corporation owns the inventory.

When the Flag Partnership distributes the shares to Danielle and Christine, the following tax consequences will arise:

- The Flag Partnership will be considered to have disposed of the shares for their tax cost of $50,000, resulting in no tax consequences.
- Each partner will be considered to have acquired the shares for an amount equal to the ACB of her partnership interest ($34,000).
- Each partner will be considered to have disposed of her partnership interest for the cost of the shares acquired from the partnership ($34,000). As a result, there is no capital gain or loss.

**We suggest you work Self Study Problem Eighteen-8 at this point.**

# Specified Investment Flow Through Partnerships

18-128. Because partnerships are not taxable entities, income is flowed through such structures without income taxes being assessed at the partnership level. As we shall see in Chapter 19, trusts are also "flow-through" entities. That is, even though trusts are taxable entities for income tax purposes, if all of their income is distributed to beneficiaries, no taxes will be paid at the trust level.

18-129. At one point in time, this flow-through feature of partnerships and trusts resulted in the conversion of a large number of business entities into publicly traded partnerships and trusts. As the government viewed this development as a significant form of tax avoidance, legislation was put in place which designated most of these publicly traded entities as specified investment flow through partnerships and trusts (SIFTs). The legislation was such that it made SIFTs sufficiently unattractive that, with the exception of real estate investment trusts, they have largely disappeared. Given this, we do not provide coverage of this subject in *Canadian Tax Principles*, except in Chapter 7, Property Income, where we have limited coverage of real estate income trusts (REITs).

**Additional Supplementary Self Study Problems Are Available Online.**

## Key Terms Used In This Chapter

18-130. The following is a list of the key terms used in this Chapter. These terms, and their meanings, are compiled in the Glossary located at the back of the Study Guide.

| | |
|---|---|
| At-Risk Amount | Limited Liability Partnership |
| At-Risk Rules | Limited Partner |
| Canadian Partnership | Limited Partnership |
| Co-Ownership | Limited Partnership Loss |
| Deeming Rule | "Negative" Adjusted Cost Base |
| General Partner | Partner |
| General Partnership | Partnership |
| Joint Tenancy | Partnership Interest |
| Joint Venture | Syndicates |
| Limited Liability | Tenancy In Common |

## References

18-131. For more detailed study of the material in this Chapter, we refer you to the following:

| | |
|---|---|
| ITA 40(3) | Negative ACB |
| ITA 53(1)(e) | Addition To Cost Base Of An Interest In A Partnership |
| ITA 53(2)(c) | Deduction From Cost Base Of An Interest In A Partnership |
| ITA 85(2) | Transfer Of Property To Corporation From Partnership |
| ITA 85(3) | Where Partnership Wound Up |
| ITA 96 | General Rules (Partnerships And Their Members) |
| ITA 97 | Contribution Of Property To Partnership |
| ITA 98 | Disposition Of Partnership Property |
| ITA 99 | Fiscal Period Of Terminated Partnership |
| ITA 100 | Disposition Of An Interest in a Partnership |
| ITA 102 | Definition Of "Canadian Partnership" |
| ITA 103 | Agreement To Share Income |
| S4-F16-C1 | What Is A Partnership? |
| IT-81R | Partnerships - Income Of Non-Resident Partners |
| IT-231R2 | Partnerships - Partners Not Dealing At Arm's Length |
| IT-242R | Retired Partners |
| IT-278R2 | Death Of A Partner Or Of A Retired Partner |
| IT-378R | Winding Up Of A Partnership |
| IT-413R | Election By Members Of A Partnership Under Subsection 97(2) |
| IT-457R | Election By Professionals To Exclude Work In Progress From Income |
| IT-471R | Merger Of Partnerships |
| T4068 | Guide for the T5013 Partnership Information Return |

# Problems For Self Study (Online)

To provide practice in problem solving, there are Self Study and Supplementary Self Study problems available on MyLab Accounting.

Within the text we have provided an indication of when it would be appropriate to work each Self Study problem. The detailed solutions for Self Study problems can be found in the print and online Study Guide.

We provide the Supplementary Self Study problems for those who would like additional practice in problem solving. The detailed solutions for the Supplementary Self Study problems are available online, not in the Study Guide.

The .PDF file "Self Study Problems for Volume 2" on MyLab contains the following for Chapter 18:

- 8 Self Study problems,
- 4 Supplementary Self Study problems, and
- detailed solutions for the Supplementary Self Study problems.

# Assignment Problems

(The solutions for these problems are only available in the solutions manual that has been provided to your instructor.)

### *Assignment Problem Eighteen - 1*

***(Existence Of Partnership)***

Barry and Lance Booker are brothers who live in the same New Brunswick community. Barry is an accountant who specializes in advising small businesses. Lance has held various jobs in restaurants over the last few years. However, he is currently between jobs.

As a result of information he has accumulated while working with his accounting clients, Barry has started a new business involving catering services. To this end, he has acquired a building, furniture, and equipment. He has also registered the business and opened up a bank account under his own name. Barry spends a few hours each day managing the business.

As he is aware of Lance's financial difficulties, he has decided to treat his brother as a partner in this business, sharing profits on a 50:50 basis when filing their annual income tax returns. There is no formal partnership agreement.

**Required:** In the following two **independent** Cases, determine whether a partnership exists.

A. Lance's involvement with the business consists of helping Barry pick out furniture and equipment and occasionally taking messages when Barry is out of town. It appears that the business will be consistently profitable.

B. Lance does all the accounting, payroll and invoicing for the business. He also does most of the ordering and is responsible for paying the suppliers. While it is unlikely that the business will be profitable in its first year of operation, Barry expects it to experience profitability in subsequent years.

## Assignment Problem Eighteen - 2

### (Existence Of Partnership)

Mr. Poliacik joined Mr. Ewing's practice by entering into a business association with Mr. Ewing. They operated under the name " Ewing/Poliacik". Mr. Poliacik made no capital contribution on joining.

Both individuals were lawyers. Mr. Poliacik's specialty was litigation. Mr. Ewing was involved in non-litigation matters.

An agreement was signed, but it never referred to the individuals as partners or the association as a partnership. When asked why they did not refer to themselves as partners, Mr. Poliacik stated that they did not know each other well enough to accept the risks of partnership. The agreement stated that all fees billed by each individual belonged to that individual.

Both parties agreed to open a combined general and trust bank account. Both parties had signing authority on the general account, although Mr. Poliacik's authority was limited to client disbursements only. Mr. Ewing had sole signing authority on the trust account. The accounts did not indicate that they were registered to a partnership.

Mr. Poliacik's fees were to be split based on a graduated scale. The first $100,000 was to be split 50:50, then 60:40 on the next $25,000, 80:20 on the next $25,000 and 90:10 thereafter. The larger percentage went to Mr. Poliacik. In addition, Mr. Poliacik was entitled to 10 percent of fees billed by Mr. Ewing to clients introduced by Mr. Poliacik.

Mr. Ewing agreed to be 100 percent liable for office expenses and bookkeeping services. Mr. Poliacik's share of the office operating expenses was $62,500 in the first year. This amount would be adjusted in the future as the expenses increased. Mr. Poliacik was not entitled to the 10 percent finder's fee from Mr. Ewing until his share of the annual expenses had been paid.

Mr. Poliacik was responsible for making his own CPP contributions and professional insurance. He will register for GST as an individual and his personal income tax return will not include a separate calculation of partnership income.

The combined business was not registered for GST purposes. There were no filings with the law society indicating that Mr. Poliacik and Mr. Ewing were partners.

**Required**: Determine whether the business association is a partnership.

## Assignment Problem Eighteen - 3

### (Partnership Vs. Joint Venture)

Chantale Bergeron is a real estate agent who had dreamed of becoming a real estate developer for a long time. In 2016, she received a substantial inheritance and purchased a tract of land with the intention of developing a group of residential lots. She paid $1,200,000 for the land which she had secretly learned from contacts would soon be adjacent to a new highway exit.

As Chantale had spent her inheritance purchasing the land and had no track record in the development business, she had difficulty in finding financing for the required $700,000 in site servicing costs. She finally located a developer, Elise Ltd. who was willing to provide the required $700,000 on an interest free basis in return for 40 percent of the profit resulting from the sale of the lots.

By December 31, 2019, it was estimated that the land's fair market value had increased to $2,000,000 because of the opening of the highway exit. During 2020, the sites are developed, with the servicing costs coming in at the estimated $700,000. All of the lots are sold prior to December 31, 2020 for total proceeds of $3,700,000.

**Case A** On December 31, 2019, Chantale and Elise Ltd. enter into a joint venture agreement. Chantale transfers the land to Elise Ltd. At the end of 2020, Elise Ltd. provides Chantale with 60 percent of the profits resulting from the development and the sale of the lots.

**Case B** On December 31, 2019, Chantale and Elise Ltd. form a partnership to develop the lots. Chantale transfers the land to the partnership using the ITA 97(2) rollover provision to defer the gain on the transfer. The partnership agreement specifies that Chantale is entitled to all of the deferred gain on the land transfer at December 31, 2019, as well as 60 percent of the profits resulting from the sale of the lots.

**Required:**

A. Calculate the amount that will be added to Chantale's Net Income For Tax Purposes in 2019 and 2020 for Case A and Case B and compare the results.

B. Assume that the Case B approach is used. Calculate the adjusted cost base of the partnership interest for both Chantale and Elise Ltd. on December 31, 2020 and January 1, 2021.

## *Assignment Problem Eighteen - 4*

### *(Partnership Income Allocation)*

Saul and Samuel Brock are brothers and Chartered Public Accountants with significant experience in tax work. Until 2019, they have worked separately. However, they have decided that working together would produce synergies that would increase their aggregate income. Given this, as of January 1, 2019, they initiate the Brock and Brock Partnership.

Saul will be entitled to a salary of $72,000 per year, while Samuel's salary will be $48,000. In addition, Samuel will receive interest at 6 percent on his average capital balance for the year. All of these amounts were withdrawn from the partnership prior to December 31, 2019. Neither brother has Taxable Income that will be taxed federally at 33 percent in 2019.

The components of their partnership agreement dealing with income allocation are as follows:

**Business Income** After the allocation of priority amounts for salaries and interest on capital contributions, any remaining business income will be allocated 60 percent to Saul and 40 percent to Samuel.

**Capital Gains** As Samuel has contributed the majority of capital to the partnership, he will be entitled to all capital gains that are recognized by the partnership.

**Dividends** Any dividends received by the partnership will be split equally between the two partners.

For the year ending December 31, 2019, their GAAP based financial statements indicate that they had net business income of $649,522. Other information related to this result is as follows:

- Salaries to Saul and Samuel of $120,000 ($72,000 + $48,000) were deducted.
- Interest on Samuel's capital contribution of $4,800 was deducted.
- Business meals of $18,976 were deducted.
- Amortization expense of $31,632 was deducted.
- Charitable contributions of $4,520 were deducted.

**Other Information**

1. For tax purposes, the brothers intend to deduct maximum CCA for 2019. This amount has been calculated to be $38,597.
2. The partnership has 2019 gains on the sale of shares held as temporary investments in the amount of $16,164.
3. The partnership receives $10,462 in eligible dividends during 2019.
4. The charitable contributions will be allocated equally between the two brothers.

**Required:**

A. Calculate the amounts of income from the partnership that would be included in the Net Income For Tax Purposes of each of the two brothers.

B. Indicate the amount of any federal tax credits that each of the two brothers would be entitled to as a result of allocations made by the partnership at December 31, 2019.

## Assignment Problem Eighteen - 5

### (Partnership Income And ACB)

On January 1, 2019, a partnership is formed between two divorce lawyers who have, for a number of years, practiced individually. Each partner contributes $70,000.

During 2019, each partner is allocated a salary of $125,000, as well as interest on their beginning of the year capital balances at an annual rate of 5 percent. These amounts are withdrawn during the year. Any Net Business Income that remains after the priority allocations for salaries and interest will be split 50:50 by the two partners.

For the year ending December 31, 2019, their bookkeeper has prepared the following financial statements for the partnership. No amortization was deducted in preparing these statements.

**Settlements Unlimited**
**Balance Sheet**
**As At December 31, 2019**

| | |
|---|---|
| Cash | $ 45,189 |
| Accounts Receivable | 186,485 |
| Work In Progress | 232,814 |
| Furniture And Fixtures | 56,581 |
| Computer Hardware (At Cost) | 17,608 |
| Computer Applications Software (At Cost) | 13,440 |
| Total Assets | $552,117 |
| | |
| Accounts Payable | $109,872 |
| Initial Partner Capital | 140,000 |
| Income For The Period | 302,245 |
| Total Equities | $552,117 |

**Settlements Unlimited**
**Income Statement**
**For The Year Ending December 31, 2019**

| | |
|---|---|
| Revenues | $682,946 |
| Meals And Entertainment | $ 23,334 |
| Office Supplies | 12,382 |
| Partners' Salaries | 250,000 |
| Interest On Capital Contributions | 7,000 |
| Rent | 46,440 |
| Salaries | 41,545 |
| Total Expenses | $380,701 |
| Income For The Period (Accounting Values) | $302,245 |

The work in progress represents work done by the lawyers at their standard charge rate that has not been billed to clients at the year end.

**Required:**

A. The lawyers have come to you to determine the minimum amount that they must include in their 2019 tax returns as business income from the partnership.

B. Compute the ACB of each partner's partnership interest at December 31, 2019 and January 1, 2020.

Your answers should ignore GST and PST considerations.

### *Assignment Problem Eighteen - 6*

***(Partnership Income And Sale Of Partnership Interest)***

Jason and Joey Blake are brothers and lawyers. While they have worked independently for several years, on January 1, 2018, they have decided to form a partnership. On January 1, 2018, they each make a capital contribution of $350,000 in cash. Because Jason's experience is in a more lucrative area of law, he is to receive 60 percent of all partnership income, with Joey receiving the remaining 40 percent. Capital gains realized by the partnership, dividends received by the partnership and charitable donations will be shared equally.

During the partnership taxation year ending December 31, 2018, the partnership has net business income for tax purposes of $335,000. The partnership had no capital gains or losses or dividend income during 2018. The partnership made no charitable donations in 2018. During this taxation year, Jason withdrew $130,000, while Joey withdrew $102,000.

The partnership's 2019 Income Statement, prepared in accordance with generally accepted accounting principles, is as follows:

**Income Statement**
**Joey And Jason Blake Partnership**
**Year Ending December 31, 2019**

| | | |
|---|---|---|
| Revenues (Note 1) | | $823,000 |
| Operating Expenses: | | |
| Rent | ($95,000) | |
| Amortization Expense (Note 2) | ( 22,000) | |
| General Office Costs | ( 42,000) | |
| Meals And Entertainment | ( 16,000) | |
| Charitable Donations | ( 12,000) | |
| Office Salaries | ( 46,000) | ( 233,000) |
| Operating Income | | $590,000 |
| Other Income: | | |
| Gain On Sale Of Investments (Note 3) | $26,000 | |
| Eligible Dividends Received From Canadian Corporations | 22,000 | 48,000 |
| Net Income | | $638,000 |

**Note 1** The revenues in the accounting based Income Statement include $105,000 in unbilled work in progress. There was no unbilled work in progress at the end of the previous year. The brothers will use the ITA 34 election to record the partnership income on a billed basis.

**Note 2** Maximum 2019 CCA, which the partners intend to deduct, is $35,000.

**Note 3** The gain resulted from the sale of temporary investments. The investments had an adjusted cost base of $57,000 and were sold for $83,000.

During 2019, Jason had drawings of $310,000 while Joey had drawings of $242,000.

During 2019, Jason's only income was from the partnership. Other than credits related to partnership allocations, Jason's only tax credit was his basic personal credit.

On January 1, 2020, Jason sells his interest in the partnership to an arm's length individual for $643,000.

**Required:** Calculate Jason's federal Tax Payable for the year ending December 31, 2019. In addition, determine the taxable capital gain or allowable capital loss that would result from Jason's sale of his partnership interest. Ignore any CPP implications with respect to self-employment income.

## Assignment Problem Eighteen - 7

### *(Withdrawal Of A Partner)*

Tammy, Loretta, and Crystal formed a partnership on January 1, 2017. The partnership is organized to provide a variety of consulting services to a broad range of clients. Each partner makes an initial capital contribution of $270,000. The partners agree to use a December 31 year end.

The partnership agreement contains the following provisions with respect to the allocation of items to individual partners:

1. Both net business income and charitable contributions will be shared equally by the three partners.
2. Any capital gains realized by the partnership will be allocated on a 50:50 basis to Crystal and Loretta.
3. All of the eligible dividends received by the partnership will be allocated to Tammy.

During the period January 1, 2017 through December 31, 2019, the partnership operates successfully. The following information related to that period:

- The partnership earned net business income of $315,000.
- Amounts not included in the net business income figure were as follows:
  - The partnership received eligible dividends totaling $6,300.
  - The partnership realized a $24,800 capital gain.
  - The partnership made charitable donations only in 2019. The total amount involved was $9,900.
- Withdrawals from the partnership were as follows:
  - Tammy - $149,000
  - Crystal - $306,000
  - Loretta - $72,000
- Additional capital was required to expand the operations of the office and, as a consequence, each partner contributed an additional $104,000 in cash.

Near the end of 2019, after a number of heated arguments with Tammy and Crystal regarding the types of clients the partnership was servicing, Loretta decides to withdraw from the partnership effective January 1, 2020. After some negotiations, each of the other partners agree to pay her $210,000 in cash for one-half of her interest in the partnership, a total of $420,000. The payments are made on February 1, 2020. The partnership has net business income of $27,600 during January, 2020.

Loretta incurred legal and accounting fees in conjunction with this withdrawal transaction totaling $2,300.

**Required:**

A. Calculate the adjusted cost base of Loretta's partnership interest as of January 1, 2020.

B. Determine the amount of Loretta's gain or loss on the disposition of his partnership interest. Explain how this amount, and any other amounts related to the partnership, will be taxed in her hands during 2020.

C. Indicate how the adjusted cost base of each partner's interest will be affected by the withdrawal of Loretta from the partnership.

### *Assignment Problem Eighteen - 8*

***(Limited Partnership)***

On January 1, 2019, Jerry Adverse purchases a 25 percent interest in income and losses of the Precipice Enterprises Partnership for $200,000. Of this total, $120,000 is paid immediately, with the remaining $80,000 due on January 1, 2020. The partnership has a December 31 year end.

The general partner of the Precipice Enterprises Partnership has agreed to buy back Jerry's interest for $100,000, without regard to its fair market value on the buy back date. However, the agreement expires on January 1, 2021.

During the year ending December 31, 2019, the Precipice Enterprises Partnership records a net business loss of $1,200,000. Also during the year, the partnership has an $80,000 capital gain.

For the year ending December 31, 2020, the Precipice Enterprises Partnership has a further net business loss of $225,000. There are no other sources of income during this year.

Jerry does not ask the general partner to buy back his interest during the year ending December 31, 2020. As a consequence, the agreement expires on January 1, 2021.

During 2021, the Precipice Enterprises Partnership has net business income of $50,000.

Jerry has sufficient other sources of income to absorb any deductible losses generated by the partnership.

**Required:** For each of 2019, 2020 and 2021, calculate the following amounts related to Jerry's interest in the Precipice Enterprises Partnership:

- The adjusted cost base at the end of the year.
- The at-risk amount.
- The limited partnership income (loss) for the year.
- The deductible income (loss) for the year.
- The limited partnership loss carry forward at the end of the year.

### *Assignment Problem Eighteen - 9*

***(Partnership Winding-Up & Transfer To Corporation)***

The Jones, Haggard, and Twitty Partnership was formed several years ago by Conway Jones, George Haggard, and Merle Twitty. To establish the partnership, each of the individuals invested $450,000 in cash. They prepared a standard partnership agreement which indicated that all income and losses would be shared on an equal basis. The partnership has a December 31 taxation year.

On January 1, 2019, the adjusted cost base of the three partnership interests are as follows:

| | |
|---|---|
| Conway Jones | $ 880,000 |
| George Haggard | 698,000 |
| Merle Twitty | 567,000 |
| Total | $2,145,000 |

The total tax cost of the partnership assets is $2,145,000, the same amount as the adjusted cost base of the partnership interests. On January 2, 2019, the net assets of the partnership are transferred to a corporation using the provisions of ITA 85(2). The elected values are equal to the tax costs of the individual assets and liabilities.

Through the use of an appraiser, it has been established that the fair market value of the partnership is $2,925,000. Using this value, the corporation provides the following consideration to the partnership:

| | |
|---|---|
| Cash | $ 900,000 |
| Preferred Shares (At Fair Market Value) | 675,000 |
| Common Shares (At Fair Market Value) | 1,350,000 |
| Total Consideration | $2,925,000 |

The partnership will be liquidated within 60 days of the ITA 85(2) rollover and property received from the corporation by the partnership will be transferred to the three partners in accordance with ITA 85(3). Under the terms of the partnership agreement, they receive the following amounts:

| | Jones | Haggard | Twitty | Total |
|---|---|---|---|---|
| Cash | $ 465,000 | $ 283,000 | $ 152,000 | $ 900,000 |
| Preferred Shares | 225,000 | 225,000 | 225,000 | 675,000 |
| Common Shares | 450,000 | 450,000 | 450,000 | 1,350,000 |
| Total | $1,140,000 | $ 958,000 | $ 827,000 | $2,925,000 |

**Required**:

A. Determine the adjusted cost base of each of the assets received by the partners as a result of the transfer of partnership assets to the corporation.

B. Calculate the capital gain or loss for each partner resulting from the transfer of the consideration received by the partnership to the partners in return for the partnership interest.

## Assignment Problem Eighteen - 10
## (Additional Business Income)

**Note** This problem involves knowledge of "additional business income" when the election of a non-calendar fiscal period is made. This material is covered in Chapter 6 of the text.

On April 1, 2016, Craig Cardinal and Don Kvill formed a partnership to teach small craft flying lessons. They elected to use a March 31 fiscal year end, to coincide with the end of the winter aircraft maintenance program and the beginning of the summer training schedule. The two partners share equally in the profits of the partnership.

In the partnership income calculation for their 2017 tax returns, the "additional business income" was calculated to be $42,200. During the year ending March 31, 2018, the partnership earned Taxable Income of $64,000 and the partners withdrew $26,000 each.

From April 1, 2018 to March 31, 2019, the partnership earned Taxable Income of $58,000 and the partners withdrew $20,000 each.

**Required**: Determine the minimum amount of partnership income that Craig Cardinal and Don Kvill will have to include in their personal tax returns for the years 2018 and 2019.

# CHAPTER 19

# Trusts And Estate Planning

## A Note On Recent Changes

### Testamentary Trusts

#### *Pre-2016 Rules*

A testamentary trust is a trust that arises on, and as a consequence of, the death of an individual. Prior to 2016, such trusts benefitted from a number of special rules that are not available to inter vivos trusts (a trust established by an individual during their lifetime). The most important of these changes was that, unlike inter vivos trusts which have all of their income taxed at the maximum federal rate of 33 percent, testamentary trusts had their income taxed using the same system of graduated rates that is applicable to individuals.

As of January 1, 2016, the special provisions for most testamentary trusts ended. This means that, like inter vivos trusts, most testamentary trusts will have all of their income taxed at the maximum federal rate of 33 percent. The ability to take advantage of the lower rates in the tax bracket schedule was a key factor in tax planning for estates. The elimination of this benefit significantly alters the contours of the estate planning landscape.

#### *The Exception - Graduated Rate Estates*

Some relief is available in those situations where the assets in an individual's estate are not yet distributed and remain under the administration of an executor. The government has provided relief through the use of special classification of testamentary trust called a Graduated Rate Estate (GRE, hereafter). As the name implies, these entities can continue to use graduated rates for up to 36 months subsequent to an individual's death. The material which follows will define and explain the use of GREs.

### Tax On Split Income (TOSI)

Our material on the TOSI is found in Chapter 11. As was noted in that Chapter, the 2018 expansion of the applicability of these provisions has created a much more complicated environment for tax planning. We also noted that complete coverage of the TOSI legislation is beyond the scope of a general text such as this. In paper, the legislation for the TOSI stretches over 23 pages and is very complex.

In Chapter 11, which dealt with the TOSI at a basic level, we did not deal with the application of the TOSI to income that trusts provide to their beneficiaries and we will not deal with the application of the TOSI in this Chapter which provides general coverage of trusts.

While we will note situations in which the TOSI might be applicable, we will not extend our examples to provide calculations of this tax.

You should not let our approach mislead you as to the importance of the TOSI to trusts. As was the case with the just discussed changes to testamentary trusts, the expansion of the TOSI coverage has significantly altered the tax planning possibilities of using trusts with related individuals.

# Introduction

19-1. As is noted in Chapter 1, the *Income Tax Act* recognizes three groups of taxpayers: individuals, corporations, and trusts. In previous Chapters we have given detailed consideration to the determination of Taxable Income and Tax Payable for both individuals and corporations. In this Chapter, we will turn our attention to how this process works in the case of trusts.

19-2. Also in Chapter 1, we provide a brief introduction to tax planning, providing general descriptions of tax avoidance, tax deferral, and income splitting. In this Chapter we will find that trusts are one of the most powerful weapons in the tax planner's arsenal. They can provide a convenient and cost effective mechanism for splitting large amounts of property income among family members. Trusts can also be used to access the deferral and income splitting opportunities that are present in estate freeze transactions. In addition, they can play a significant role in many other tax and business planning arrangements.

19-3. While trusts remain a very powerful tax planning tool, as was noted in our introductory note regarding 2016 changes, their effectiveness in estate planning has been greatly reduced by the elimination of graduated rates for most testamentary trusts.

19-4. A further problem is that dealing with trusts requires an understanding of many legal issues that cannot be handled effectively by tax advisors alone. Further, legal advice in the area of trusts can be very expensive, with charges of $500 per hour or more being common for expert advice. When combined with an accountant's fees (which can vary greatly depending on the accountant), the costs to create and maintain a trust can be prohibitive. Since normally, the settlor (creator) of a trust doesn't personally benefit financially from creating a trust, this makes the high cost of a trust even less acceptable to the settlor.

19-5. We have previously encountered trusts in this text. In Chapter 7, which deals with property income, we indicated that most mutual funds are organized as trusts. Also in that Chapter, we noted the use of real estate investment trusts (REITs). In Chapter 10, when we considered various types of retirement savings arrangements, we noted that most of these arrangements involve the use of trusts. Registered Pension Plans, Registered Retirement Savings Plans, Registered Retirement Income Funds, and Deferred Profit Sharing Plans, all involve assets being contributed to a trust.

19-6. In this Chapter, we will not revisit the types of trusts that were considered in earlier Chapters. Rather, our focus in this Chapter will be on personal trusts that have been established by individuals as a part of a tax or estate planning scenario. This will include both trusts established during the lifetime of an individual, as well as trusts that arise as a consequence of the death of an individual. While trusts can be very important in tax planning arrangements that involve private corporations, we will not deal with this subject. The complexities involved in such arrangements go beyond the scope of this text.

19-7. In our material in this Chapter on estate planning we will give specific attention to the use of trusts. In addition, due to the importance of this subject, we will expand our coverage of estate planning to issues that go beyond the use of trusts. Particular attention will be given to general coverage of estate freeze transactions.

**Figure 19 - 1 Personal Trust Participants**


# Basic Concepts

## What Is A Trust?

### *Legal Perspective*

19-8. From a legal perspective, a personal trust is a relationship that arises when a settlor transfers property to a trustee to hold and administer for the exclusive benefit of the beneficiaries. This relationship is depicted in Figure 19-1.

19-9. The settlor is the person who sets up the trust and makes the initial transfer of property to the trustee. The trustee is the individual or institution that holds formal legal title to that property, while the beneficiaries are persons who will benefit from the property that is held by the trustee. The beneficiaries can have an interest in the income from the property, the capital value of the property, or both.

19-10. While each of these roles is separate in terms of its function in the trust arrangement, it is possible for more than one of the roles to be played by a single individual. A common example of this would be a father who is the settlor of a trust in favour of his children, but also serves as one of the trustees who holds the trust assets.

19-11. A basic feature of trust arrangements is the separation of the legal and beneficial ownership of the transferred property. Outside of trust arrangements, the legal owner of a property is normally entitled to any benefits associated with owning the property. This is not the case here. While the trustee holds legal title to the property, all of the benefits will accrue to the persons who are specified as the beneficiaries of the trust.

19-12. A trust is not, from a legal perspective, a separate entity. A trust cannot own property, cannot enter into contracts, and cannot be a defendant or plaintiff in a legal action. With respect to the transferred property, these rights and obligations belong to the trustee(s). We would note that you should not confuse trusts with a "trust company". Trust companies are, in fact, separate legal entities that are involved in the management of trusts.

19-13. Trusts are subject to provincial legislation and, as a consequence, the detailed rules will vary from province to province. One point to note, however, is that it is generally difficult to vary or revoke a trust. This is of particular importance in the case of deceased individuals. While the content of a will can be challenged by a disgruntled beneficiary and its intentions altered by a surviving spouse, this is a much more difficult process when assets are placed in a trust.

### *Tax Perspective*

19-14. Consistent with the legal perspective of trusts, the T4013 Trust Guide defines a trust as a binding obligation enforceable by law when undertaken. This definition also notes that it may be created by a person (either verbally or in writing), a court order, or by a statute.

19-15. While trusts do not exist as a legal entity separate from the trustees, income tax legislation does, in fact, treat trusts as a separate taxable entity, resulting in the need to file a separate tax return (T3) for each trust. This is established in the *Income Tax Act* as follows:

> **ITA 104(2)** A trust shall, for the purposes of this Act, and without affecting the liability of the trustee or legal representative for that person's own income tax, be deemed to be in respect of the trust property an individual, ...

19-16. This provision means that, in general, a trust will be taxed in the same manner as individuals. However, there are numerous special rules applicable to these entities. For example, most trusts cannot use the graduated rates (15 percent to 33 percent) that are available to individuals. However, each trust will have to determine a Net Income For Tax Purposes, a Taxable Income, and calculate a separate Tax Payable.

### Trusts And Estates

19-17. When an individual dies, there is a deemed disposition of all of his capital property. Property will be deemed to have been acquired at its fair market value on the date of death by various entities as per his will or, if there is no will, under the terms of provincial legislation. As discussed in Chapter 9, this deemed disposition will often have significant consequences on the calculation of Tax Payable in the final tax return of the decedent, i.e., deceased individual.

19-18. In this context, dictionaries define the term "estate" as the property of a deceased individual. This meaning is very clearly a reference to all of the property of the deceased individual and this, in effect, means that an individual can only have one estate.

19-19. In the great majority of cases, the estate property will pass to a beneficiary or beneficiaries immediately and will not require much attention from either tax advisors or lawyers. For example, Mom dies, leaving all of her property, which consists of a savings account and a principal residence, both of which are jointly held with Dad, to Dad. We do not need to give any attention to this type of situation.

19-20. However, some estates, particularly those of wealthier Canadians, can have many different types of property. This can include, publicly traded securities, shares of private companies, rental properties, business assets, and foreign investments. In such cases, there may be a considerable period of time between the date on which the individual dies and the date on which all the assets, or the proceeds from the disposition from the assets, is transferred to his beneficiaries. During this period, the estate assets, which are being administered by an executor, can produce income. When this happens, the executor of the estate will have to file a T3 return which includes this income.

19-21. As reflected in the following provision, the *Income Tax Act* has traditionally viewed the terms estate and trust as pretty much interchangeable:

> **ITA 104(1)** In this Act, a reference to a trust or estate (in this subdivision referred to as a "trust") shall, ...

19-22. As long as testamentary trusts were able to use graduated rates in determining their Tax Payable, using the two terms interchangeably did not present a problem. While deciding to tax the income of testamentary trusts in general at the maximum rate, the government also concluded that it would be appropriate to continue the use of graduated rates for income that accrues during the period of time that the estate assets have not yet been distributed.

19-23. To implement this latter goal, the government introduced the concept of a Graduated Rate Estate (GRE). While we will give more attention to this concept at a later point in this chapter, you should be aware that GREs can only be used for assets that are still held in the estate and administered by an executor prior to their distribution to beneficiaries.

## Establishing A Trust

### Three Certainties

19-24. The trusts that we are dealing with in this Chapter are established by words that are set out in a trust agreement. While some provinces allow, under limited circumstances, the use of oral trust agreements, this is rarely a wise course of action. Even if such agreements are accepted for legal purposes, the CRA tends to be skeptical of such agreements and may take the position that no trust exists.

19-25. In deciding whether or not a trust has, in fact, been created, it is important to look at what the courts have referred to as the three certainties. These can be described as follows:

**Certainty Of Intention** The person creating the trust must intend to create the trust and that intention must be clear to outside observers. This is usually accomplished by preparing a written document establishing the trust.

**Certainty Of Property** The property that is to be held in the trust must be known with certainty at the time the trust is created. This is usually accomplished by specifying the property in the trust document.

**Certainty Of Beneficiaries** The persons who will benefit from the trust property must be known with certainty at the time the trust is created. This is usually accomplished by specifying these persons in the trust document. Note that these persons must either be named as persons (e.g., Ms. Sally Phar) or be part of an identifiable class (e.g., my children). When a class designation is used, it must refer to a clearly identifiable group of persons. For example, designating "friends" as beneficiaries would not create an identifiable group.

19-26. In addition to establishing the facts required by the three certainties criteria, there must be an actual transfer of the trust property to the trustee. Until this transfer is completed, the trust does not exist.

### Importance Of Proper Documentation

19-27. Care must be taken to ensure that all of the necessary actions to create a trust have been carried out effectively. If one or more of the required elements is missing, the tax consequences can be significant. For example, if an individual attempted to establish a trust to split income with his adult children, a failure to complete all of the requirements necessary to that process could result in his being taxed on the income, rather than having it taxed in the hands of his adult children. This could result in the payment of a significant amount of additional tax.

### Exercise Nineteen - 1

**Subject:** Establishing A Trust

In each of the following Cases, an individual is attempting to establish a trust. For each of these Cases, indicate whether the attempt has been successful. Explain your conclusion.

**Case A** Jack Black sends a cheque to his sister to be used for the education of her two children.

**Case B** Jane Folsem transfers property to a trustee, specifying that the income from the property should be distributed to her friends.

**Case C** Robert Jones transfers property to a trustee, specifying that the income from the property should be distributed to his children.

**Case D** Suzanne Bush has signed an agreement that specifies that she will transfer her securities portfolio to a trustee, with the income to be distributed to her spouse.

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## Returns And Payments - Trusts

19-28. Because they are considered by the government to be taxable entities, trusts must file tax returns. As discussed in Chapter 2, Procedures and Administration, the trust tax return (T3 return) must be filed within 90 days of a trust's year end. With respect to the payment of taxes, the tax payable on trust income is due no later than 90 days after a trust's year end. We also noted in Chapter 2 that, while there is a legislative requirement that most trusts make instalment payments, the CRA has waived this requirement on an administrative basis in the past. It appears that this practice will continue in the future.

19-29. With respect to penalties and interest related to late filing or late payment of taxes, the rules for trusts are the same as those that are applicable to individuals.

## Non-Tax Reasons For Using Trusts

19-30. In this Chapter we are largely concerned with the tax planning uses of trusts. However, it is important to note that trusts have non-tax uses which, in some situations, may be more important than the tax features of the particular arrangement. Some of these non-tax uses are as follows:

**Administration Of Assets** A trust can be used to separate the administration of assets from the receipt of benefits. For example, an individual with extensive investment knowledge might have assets transferred to a trust for his spouse at the time of his death. The goal here could be to provide professional management of the assets for the benefit of a spouse with only limited knowledge of investments.

**Protection From Creditors** An individual proprietor of a business might place some of his personal assets in a trust in order to protect them from claims by the creditors of the business. However, if this transfer is made when the individual is experiencing financial difficulties with his business, there are provisions in bankruptcy and other legislation which may undo the transfer.

**Privacy** If assets are bequeathed in a will, they will be subject to probate, the results of which are available to the public. This is not the case with assets that are in a trust when an individual dies.

**Avoiding Changes In Beneficiaries** If a father places assets in a trust for the benefit of his minor children, it ensures that these children will be the ultimate beneficiaries of the property. In contrast, if, as is common, his will bequeaths his assets to his wife with the intention that his children will be the ultimate beneficiaries of his property, his wife has no legal obligation to carry out this intention. This can be a particularly important issue if the surviving spouse remarries and other children become part of her family.

19-31. While there are additional examples of non-tax uses of trusts, the preceding should serve to give you some idea of the versatility of trust arrangements.

# Classification Of Trusts

## Introduction

19-32. The CRA's *Trust Guide* lists 32 different types of trusts, largely based on definitions that are included in the *Income Tax Act*. Understanding the meaning of the terms on this CRA list is complicated by the fact that some of the listed items are, in fact, a sub-classification of other items included on the list (e.g., an alter ego trust is a type of personal trust). A further roadblock to understanding the classification of trusts is that trusts are also classified in popular usage in terms of their goals or objectives. Such terms as "family trusts" and "spendthrift trusts" are commonly used, despite the fact that they have no real meaning in terms of tax legislation.

19-33. In this material, we will not provide a comprehensive classification of trusts, nor will we attempt to provide definitions for all of the terms that are applied to trusts in tax legislation and general practice. As indicated in the introduction to this Chapter, our coverage is limited to trusts that have been established by individuals as part of a tax or estate planning scenario. As all of these trusts fall within the classification of personal trusts, we will begin by considering this category.

## Personal Trusts

### *General Definition*

19-34. The *Income Tax Act* contains the following definition of a personal trust:

**ITA 248(1) Personal Trust** means

(a) a graduated rate estate, or

(b) a trust in which no beneficial interest was acquired for consideration payable directly or indirectly to
 (i) the trust, or
 (ii) any person or partnership that has made a contribution to the trust by way of transfer, assignment or other disposition of property;

19-35. The basic idea here is that a personal trust is one which was not acquired for consideration paid to the trust or to any person that has contributed to the trust. An exception is made for graduated rate estates. Prior to 2016, this exception applied to all testamentary trusts.

19-36. The importance of this inclusion for Graduated Rate Estates is that personal trusts can pay taxes on income amounts received by the trust at the trust level. The after tax amounts can then be distributed on a tax free basis to the beneficiaries of the trust.

### Testamentary Vs. Inter Vivos Trusts

19-37. All personal trusts can be classified as either testamentary or inter vivos. With respect to testamentary trusts, they are defined as follows:

**ITA 108(1) Testamentary Trust** in a taxation year means a trust that arose on and as a consequence of the death of an individual, other than ...

19-38. This same Subsection of the *Income Tax Act* provides a related definition of an inter vivos trust:

**ITA 108(1) Inter Vivos Trust** means a trust other than a testamentary trust.

19-39. Within each of these classifications, there are various subclassifications. In this Chapter, we will deal with three types of testamentary trusts and four types of inter vivos trusts. The types that we will cover are outlined in Figure 19-2:

**Figure 19 - 2 Classification Of Personal Trusts**

| Testamentary | Inter Vivos |
|---|---|
| Graduated Rate Estate | Spousal Or Common-Law Partner |
| Spousal Or Common-Law Partner | Alter Ego |
| Other Beneficiaries | Joint Spousal Or Common-Law Partner |
| | Family |

## Testamentary Trusts

### Graduated Rate Estate

19-40. As discussed in the note at the beginning of this Chapter, prior to 2016, testamentary trusts enjoyed a number of special rules which were not available to inter vivos trusts such as:

- The ability to calculate Tax Payable using the graduated rate schedule that is available to individuals, rather than having Tax Payable calculated using the maximum rate on all income.
- The ability to use a non-calendar fiscal period.
- Classification as a personal trust without regard to the circumstances in which the beneficial interest was acquired.
- Exemption from the requirement to make instalment payments.
- Use of the $40,000 exemption in calculating alternative minimum tax.
- Extended periods for refunds, reassessment, and filing of objections.
- The ability to make investment tax credits available to their beneficiaries for computing their Tax Payable.

19-41. The government concluded that these provisions were, in many situations, overly generous. Reflecting this view, as of January 1, 2016 these special rules are no longer generally available for testamentary trusts.

19-42. An exception to this is the Graduated Rate Estate (GRE). These are defined in ITA 248(1) as follows:

> **ITA 248(1) graduated rate estate**, of an individual at any time, means the estate that arose on and as a consequence of the individual's death if
>
> (a) that time is no more than 36 months after the death,
> (b) the estate is at that time a testamentary trust,
> (c) the individual's Social Insurance Number (or if the individual had not, before the death, been assigned a Social Insurance Number, such other information as is acceptable to the Minister) is provided in the estate's return of income under Part I for the taxation year that includes that time and for each of its earlier taxation years that ended after 2015,
> (d) the estate designates itself as the graduated rate estate of the individual in its return of income under Part I for its first taxation year that ends after 2015, and
> (e) no other estate designates itself as the graduated rate estate of the individual in a return of income under Part I for a taxation year that ends after 2015;

19-43. While it is not perfectly clear from this definition, a GRE is only applicable to estate assets that have not been transferred to a beneficiary, either individual beneficiaries or testamentary trust beneficiaries. Stated alternatively, only if the estate has assets that are still under the administration of an executor can it be designated as a GRE.

> **EXAMPLE 1** Gary Crotty dies on November 1, 2019. His estate (all of his property at death) consists entirely of publicly traded securities that are, under the terms of his will, immediately transferred to a spousal trust.
>
> **ANALYSIS - Example 1** No GRE can be designated in this case because none of the decedent's assets remain under the administration of his executor.

> **EXAMPLE 2** Lizabeth Jerrard dies on November 1, 2019. Her will requires that all of her estate be transferred to a spousal trust. Her estate consists of a large number of investments in real estate and CCPC shares, some of which will take considerable time to dispose of or transfer. As of December 31, 2022, some of the estate assets are still under the administration of the executor.
>
> **ANALYSIS - Example 2** The executor will be required to file a T3 for the income accruing on these assets. In the first return, which can have a year end no later than October 31, 2020, the estate can be designated a GRE. As long as the estate assets remain under the administration of the executor, this designation can be used in the T3s filed within 36 months of her death. On December 31, 2022, even if there still undistributed estate assets, there will be a deemed year end. In that return and any subsequent to that date, the estate will be taxed as an ordinary testamentary trust, with all of its income subject to the maximum 33 percent rate. Note that, if the required transfer of all assets to the spousal trust had occurred prior to November 1, 2022, the estate would have lost its GRE status at that date.

19-44. Two points are relevant here:

- Because GREs are included in the definition of a personal trust, its income can be taxed in the trust. The GRE can then distribute the after tax amounts to income beneficiaries on a tax free basis.
- If some of an estate's assets are distributed to beneficiaries, the portion that remains under the administration of an executor can be designated as a GRE.

### Spousal Or Common-Law Partner Trust

19-45. This category of trust is not defined in the *Income Tax Act*. Rather, it is a term that is used when a trust is established for a spouse or common-law partner. As shown in Figure 19-2, such trusts can either be an inter vivos trust established by a living person or, alternatively, a testamentary trust that is established when an individual dies. A spousal or common-law partner testamentary trust can never be designated a graduated rate estate.

19-46. As will be discussed when we present material on the taxation of trusts, if a trust meets certain conditions, the *Income Tax Act* allows a settlor to transfer property into a trust without incurring any taxation on the property dispositions. The relevant rollover provisions are found in ITA 73(1.01) for inter vivos trusts, and in ITA 70(6) for testamentary trusts. When these provisions are used, the resulting trust is usually referred to as a qualifying spousal or qualifying common-law partner trust.

### Other Beneficiaries

19-47. Although listed in Figure 19-2 as a type of trust, it represents a testamentary trust that is not a spousal or common-law partner trust. Common other beneficiaries would be the decedent's children or other close relatives of the decedent. Such trusts can never be designated a graduated rate estate.

## Inter Vivos Trusts

### Spousal Or Common-Law Partner Trust

19-48. As noted in Paragraph 19-45, spousal or common-law partner trusts can be established as testamentary trusts on the death of the settlor or, alternatively, as inter vivos trusts by a living individual.

### Alter Ego Trust

19-49. An alter ego trust is an inter vivos trust created by an individual who is 65 years of age or older with himself as the sole beneficiary during his lifetime. As was the case with spousal or common-law partner trusts, if certain conditions are met, the *Income Tax Act* contains a rollover provision that allows property to be transferred into or out of the trust on a tax free basis.

### Joint Spousal Or Common-Law Partner Trust

19-50. A joint spousal or joint common-law partner trust is an inter vivos trust created by an individual who is 65 years of age or older. Similar to the alter ego trust, this type of trust is created with the individual and his spouse or common-law partner as the sole beneficiaries during their lifetimes. Also similar to the alter ego trust scenario, if certain conditions are met, there is a rollover provision in the *Income Tax Act* that allows property to be transferred into the trust on a tax free basis.

### Family Trust

19-51. While the term family trust is not always used in a consistent manner, it generally refers to a trust that has been established by an individual for the benefit of family members. While a family trust could be a testamentary trust, the term is usually used in reference to an inter vivos trust. The most common goal of this type of trust is income splitting. We would note that the extension of the TOSI to related adults has placed significant constraints on using trusts for this purpose.

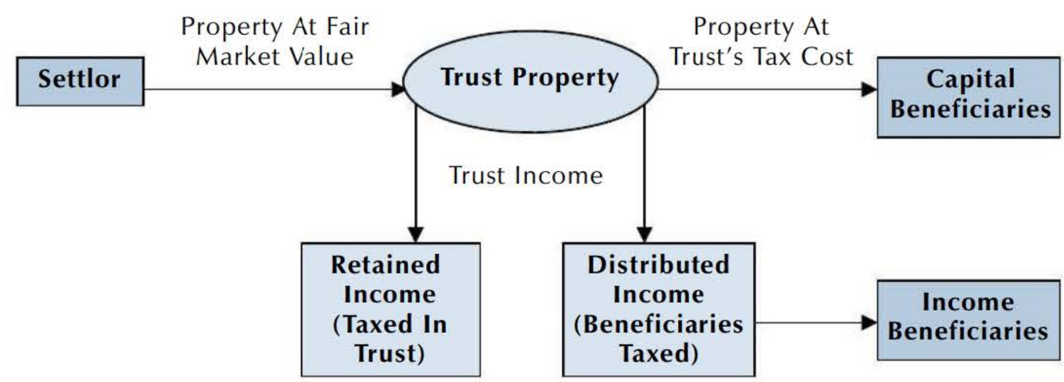
# Taxation Of Trusts

## Taxation Year

19-52. Inter vivos trusts have always been required to use the calendar year as their taxation year. In contrast, prior to 2016, testamentary trusts were allowed to use a non-calendar fiscal year. As of 2016, testamentary trusts have, in general, lost this right.

19-53. The exception to this is Graduated Rate Estates (GREs). As long as estate assets are

**Figure 19 - 3**
**Basic Taxation Model For Trusts**




under the administration of an executor and have not been distributed to beneficiaries, GREs can use a non-calendar fiscal period for up to 36 months subsequent to the decedent's date of death.

## The Basic Taxation Model

19-54. While there are many variations that depend on the particular type of trust we are dealing with, as well as complications associated with the measurement of trust Taxable Income and Tax Payable, the basic model for the taxation of trusts is as shown in Figure 19-3. There are three features of this basic model that should be noted:

**Settlor's Transfer Of Property To The Trust** When property is transferred to a trust by a settlor, it generally results in a disposition for tax purposes. In the usual situation, these dispositions are deemed to occur at fair market value, triggering various tax consequences (e.g., capital gains, recapture, or terminal losses). There are, however, some important rollover provisions for property transferred into a trust. These are discussed beginning in Paragraph 19-56.

**Transfers Of Trust Property To Beneficiaries** If trust property is transferred to a capital beneficiary, ITA 107(2) provides a rollover provision that allows the property to be transferred at the tax cost to the trust. The proceeds of disposition to the trust and the cost to the beneficiary will be equal to the tax cost that is recorded in the trust. For exceptions to this general provision, see Rollovers To Beneficiaries beginning in Paragraph 19-69.

**Income From The Trust Property** Once property has been transferred to the trust, income will begin to accrue to the trust. It is fundamental to most of the tax planning uses of trusts that income earned in the trust can be deducted by the trust from Net Income For Tax Purposes of the trust to the extent that it is either distributed to beneficiaries or they are entitled to enforce payment. We will find that in many situations, trusts will distribute all of their income, resulting in no Tax Payable at the trust level.

Any income that a trust does not distribute to beneficiaries will be taxed in the trust. Subsequent distribution of this income is on a tax free basis. At this point you should note that there is a very important difference in the calculation of Tax Payable for a testamentary trust that is designated as a graduated rate estate, and the calculation of Tax Payable for other personal trusts. As the name implies, graduated rate estates can use the schedule of graduated rates that is applicable to individuals. In contrast, most other personal trusts will have all of their income taxed at the maximum rate of 33 percent.

19-55. While it is not illustrated in Figure 19-3, there is a special anti-avoidance rule that is designed to prevent extended deferral of the potential tax on capital gains. This rule requires

a deemed disposition of capital assets after they have been held in the trust for 21 years and will be discussed in detail beginning in Paragraph 19-75.

## Exercise Nineteen - 2

**Subject**: Basic Taxation Of Trusts

On January 1, 2019, Joanne March transfers debt securities with a fair market value of $220,000 to a newly established inter vivos trust for which her 28 year old daughter, Jocelyn, is the only beneficiary. The cost of these securities to Joanne March was $200,000. During 2019, the securities earn and receive interest of $15,000, all of which is distributed to Jocelyn. On January 1, 2020, the securities are transferred to Jocelyn in satisfaction of her capital interest in the trust. At this time, the fair market value of the securities has increased to $230,000. Jocelyn sells all of the securities for $230,000 on January 5, 2020. Joanne is not a trustee of the inter vivos trust.

Indicate the tax consequences for Joanne, Jocelyn, and the trust, in each of the years 2019 and 2020.

**SOLUTION available in print and online Study Guide.**

## Rollovers To A Trust

### *Introduction*

19-56. The general taxation model for trusts requires that contributions to the trust be recorded at fair market value, often resulting in a significant tax cost for the contributor. However, as we noted in our material on the classification of trusts, spousal or common-law partner trusts, alter ego trusts, and joint spousal or common-law partner trusts can receive such transfers on a rollover basis, provided certain specific conditions are met.

19-57. In this section we are concerned with the conditions that qualify these three special types of trusts for the tax free rollover of contributions. When the trust qualifies, the rollover is accomplished by deeming the property to have been disposed of by the settlor at either its adjusted cost base (non-depreciable capital property) or its UCC (depreciable capital property), resulting in no tax consequences for the settlor at the time of transfer. The trust is deemed to have acquired the property at a value equal to the proceeds of disposition to the settlor. In the case of depreciable property, the trust retains the settlor's original capital cost for purposes of determining recapture of CCA.

19-58. We will revisit these three types of trusts in our later section on tax planning. At that point we will discuss how these trusts can be used to reduce or defer taxes.

### *Qualifying Spousal Or Qualifying Common-Law Partner Trust*

19-59. You may recall from Chapter 9 that ITA 73(1.01) contains a rollover provision that allows a living individual to transfer capital property to a spouse or common-law partner without tax consequences. ITA 70(6) provides for a similar rollover for the capital property of a deceased individual.

19-60. While we did not discuss this in Chapter 9, these rollovers apply whether the transfer is directly to the spouse or common-law partner or, alternatively, to a trust in favour of a spouse or common-law partner. However, in the case of a transfer to a trust, the trust arrangement must meet certain conditions in order to qualify for the rollover. When it meets these conditions, it is commonly referred to as a qualifying spousal or common-law partner trust.

19-61. With respect to inter vivos spousal or common-law partner trusts, the conditions for qualifying for the rollover are as follows:

**ITA 73(1.01)(c)(i)** The individual's spouse or common-law partner is entitled to receive all of the income of the trust that arises before the spouse's or common-law partner's death and no person except the spouse or common-law partner may, before the spouse's or common-law partner's death, receive or otherwise obtain the use of any of the income or capital of the trust.

19-62. A similar provision provides the rollover conditions for testamentary spousal or common-law partner trusts:

**ITA 70(6)(b)** A trust, created by the taxpayer's will, that was resident in Canada immediately after the time the property vested indefeasibly in the trust and under which

(i) the taxpayer's spouse or common-law partner is entitled to receive all of the income of the trust that arises before the spouse's or common-law partner's death, and

(ii) no person except the spouse or common-law partner may, before the spouse's or common-law partner's death, receive or otherwise obtain the use of any of the income or capital of the trust.

19-63. When these conditions are met, any property that is contributed to the trust, either by a living spouse or common-law partner, or as the result of the spouse or common-law partner's death, will be transferred at tax cost. For non-depreciable capital property, this value is the transferor's adjusted cost base. For depreciable property, the transfer is at the transferor's UCC amount. However, for purposes of determining recaptured CCA, the transferor's original capital cost is deemed to be the transferee's capital cost.

19-64. While these rollover provisions are, in general, a desirable way to avoid paying taxes on transfers to a spousal or common-law partner trust, there may be circumstances where the taxpayer would prefer a transfer at fair market value. For example, if the settlor of the trust has unused capital loss carry forwards or property that is eligible for the lifetime capital gains deduction, he might wish to trigger capital gains in order to absorb these amounts. Fortunately, the settlor has the choice of electing out of the rollover provisions. For inter vivos transfers, the election is under ITA 73(1). For testamentary transfers the election that can be made by the settlor's legal representative is under ITA 70(6.2).

## Exercise Nineteen - 3

**Subject:** Transfer To Spousal Trust

Louise died late this year, and bequeathed a group of common stocks to a qualifying spousal trust created in her will. Louise is survived by her husband who is to receive the stocks from the trust three years after her death if they have not been sold. The stocks have an adjusted cost base of $60,000 and were valued at $90,000 on the date of her death. Determine the tax consequences of the transfer, including the adjusted cost base for the stocks in the trust and in her husband's hands if they are transferred.

**SOLUTION available in print and online Study Guide.**

### *Alter Ego Trust*

19-65. An alter ego trust is an inter vivos trust established by a settlor who is 65 years of age or older at the time the trust is settled. To qualify for a tax free rollover of assets to the trust, the *Income Tax Act* specifies the following conditions:

**ITA 73(1.01)(c)(ii)** The individual is entitled to receive all of the income of the trust that arises before the individual's death and no person except the individual may, before the individual's death, receive or otherwise obtain the use of any of the income or capital of the trust.

19-66. As was the case with the spousal or common-law partner trust, an individual can elect out of this rollover, choosing to have the transfer to the trust take place at fair market value.

### *Joint Spousal Or Joint Common-Law Partner Trust*

19-67. Like an alter ego trust, a joint spousal or common-law partner trust is an inter vivos trust established by a settlor who is 65 years of age or older at the time the trust is settled. The difference in this case is that both the settlor and his spouse or common-law partner are beneficiaries of the trust. More specifically, to qualify for the tax free rollover of assets to the trust, the *Income Tax Act* specifies the following conditions:

**ITA 73(1.01)(c)(iii)** either

(A) the individual or the individual's spouse is, in combination with the other, entitled to receive all of the income of the trust that arises before the later of the death of the individual and the death of the spouse and no other person may, before the later of those deaths, receive or otherwise obtain the use of any of the income or capital of the trust, or

(B) the individual or the individual's common-law partner is, in combination with the other, entitled to receive all of the income of the trust that arises before the later of the death of the individual and the death of the common-law partner and no other person may, before the later of those deaths, receive or otherwise obtain the use of any of the income or capital of the trust.

19-68. As was the case with the alter ego trust, an individual can elect out of this rollover, choosing to have the transfer to the trust take place at fair market value.

### Exercise Nineteen - 4

**Subject:** Transfers To Trusts

An individual has common shares with a cost of $1,000 and a current fair market value of $1,600. Seven Scenarios are presented for the transfer of these shares by the settlor to a trust. For each Scenario, indicate the tax consequences to the settlor at the time of transfer, as well as the adjusted cost base of the property within the trust.

Scenario 1: Transfer to inter vivos trust for adult child.
Scenario 2: Transfer to inter vivos trust for minor child.
Scenario 3: Transfer to testamentary trust for friend.
Scenario 4: Transfer to inter vivos qualifying spousal trust.
Scenario 5: Transfer to testamentary qualifying spousal trust.
Scenario 6: Transfer to joint spousal trust.
Scenario 7: Transfer to alter ego trust.

**SOLUTION available in print and online Study Guide.**

## Rollovers To Capital Beneficiaries

### *General Rule*

19-69. As is the case with transfers by a settlor into a trust, the transfer of assets to a capital beneficiary is a disposition. However, for many trusts ITA 107(2) provides a tax free rollover for these transfers. The rollover is accomplished by deeming the property to have been disposed of by the trust at either its adjusted cost base (non-depreciable capital property) or its UCC (depreciable property).

19-70. The beneficiary is deemed to have acquired the property at a value equal to the cost amount to the trust, resulting in no tax consequences at the time of transfer to the beneficiary. In the case of depreciable property, the beneficiary retains the capital cost of the property to the trust for purposes of determining subsequent recapture of CCA.

### Exceptions

19-71. The logic of the preceding rule is based on the fact that the transfer of assets into the trust was, in terms of the beneficial interest in the assets, a transfer of the assets to the beneficiaries. Provided that tax was assessed on the transfer into the trust, it would not be equitable to assess tax again when the asset is legally transferred to the beneficiaries.

19-72. We have noted, however, that with certain types of trusts, the transfer from the settlor to the trust is not a taxable transaction. Specifically, qualifying spousal or common-law partner trusts, alter ego trusts, and joint spousal or common-law partner trusts can use a rollover provision to transfer assets into a trust. Since no tax was assessed on the transfer into these trusts, it would not seem equitable to allow the assets to be transferred to all beneficiaries on a rollover basis.

19-73. Tax legislation agrees with this view. The ITA 107(2) rollover does not apply in the following cases:

- if property is transferred out of an **alter ego** trust to anyone other than the settlor,
- if property is transferred out of a **joint spousal** or common-law partner trust to anyone other than the settlor or the spouse or common-law partner, and
- if property is transferred out of a **qualifying spousal** or common-law partner trust to anyone other than a spouse or common-law partner.

19-74. When the ITA 107(2) rollover provision does not apply, the transfer of assets from the trust to a capital beneficiary will be recorded at the fair market value of the transferred assets. This will generally result in tax consequences for the trust.

**We suggest you work Self Study Problem Nineteen-1 at this point.**

## 21 Year Deemed Disposition Rule

19-75. Trust arrangements ordinarily allow capital gains on trust assets to accumulate without tax consequences for extended periods of time. Unless the capital assets are sold or distributed by the trust, accrued gains will not attract any taxes and the assets can be left in a trust for periods that exceed the life of the individual establishing the trust.

19-76. In order to place limits on this deferral process, ITA 104(4)(b) requires that there be a deemed disposition and reacquisition of trust capital property every 21 years. The disposition is deemed to be at fair market value, resulting in the recognition of any accrued gains on the assets. In the case of depreciable assets, if the deemed proceeds are less than the original capital cost, the original value is retained for purposes of determining recapture.

19-77. This rule is generally applicable only to personal trusts and does not apply to trusts such as employee benefit plans or registered education savings plans. Further, the rules are modified in the case of qualifying spousal or common-law partner trusts, alter ego trusts, and joint spousal or common-law partner trusts.

## Other Deemed Dispositions

19-78. For qualifying spousal or common-law partner trusts, a deemed disposition occurs with the death of the spouse or common-law partner. In the case of alter ego trusts, the death of the settlor is the event that triggers a deemed disposition. Finally, with joint spousal or common-law partner trusts, the deemed disposition occurs only at the later of the death of the settlor or the death of the spouse or common-law partner.

# Net Income For Tax Purposes Of A Trust

## Basic Rules

19-79. The overriding principle in determining the Net Income For Tax Purposes of a trust results from the statement in ITA 104(2) that a trust should be treated as an individual. This means that the general rules used by individuals, as modified by trust legislation, are applicable in computing a trust's Net Income For Tax Purposes.

19-80. Capital gains and losses are realized on the disposition of capital assets. Also, in the calculation of Net Income For Tax Purposes, any taxable dividends that are not allocated to beneficiaries are grossed up as they would be for individuals. Finally, deductions are allowed for non-capital, net capital, and certain other types of loss carry overs.

19-81. There are, however, additional items that must be added or deducted in calculating the Net Income For Tax Purposes of a trust. These items can be described as follows:

**Amounts Paid Or Payable To Beneficiaries** As was noted in our description of the basic trust taxation model, a trust can deduct amounts that are paid or payable to one or more beneficiaries. This is usually the most important of the adjustments to the trust's income in that, in many cases, all of the trust's income will be allocated to beneficiaries. Because of the importance of this deduction, it will be the subject of a separate section of this Chapter beginning in Paragraph 19-93.

**Trustee's Or Executor's Fees** Any amounts paid that are related to earning trust income, or that are paid to an executor or trustee whose principal business includes the provision of such services, are deductible to the trust.

**Amounts Paid By The Trust And Allocated To The Income Of A Beneficiary** A trust can make payments to third parties to provide goods or services to beneficiaries. The CRA considers such amounts to be another way of paying income to beneficiaries and, as a consequence, such amounts are deductible to the trust and included in the income of the beneficiaries.

**Income Allocated To A Preferred Beneficiary** As will be discussed beginning in Paragraph 19-83, trusts can allocate income to a preferred beneficiary while retaining the income in the trust. While such retained income would normally be taxed in the trust, because it is being taxed in the hands of a beneficiary, it can be deducted from the income of the trust.

**Amounts Deemed Not Paid** A trust can designate amounts to be deemed not paid when they are, in fact, paid or payable to beneficiaries. This means that the trust will include these amounts in its own Net Income For Tax Purposes and the beneficiaries will be able to receive these amounts on a tax free basis. The reasons for doing this are discussed beginning in Paragraph 19-86.

**Amounts Retained For Beneficiary Under 21 Years Of Age** Provided the eventual payment is not subject to any future condition, amounts that are held in trust for a beneficiary who is under 21 at the end of the year can be deducted by the trust and taxed in the hands of the beneficiary. (See Paragraph 19-90.)

19-82. While positive amounts of all types of income can be allocated to beneficiaries, losses cannot be. If a trust has a disposition that results in a capital loss, or other activities that result in a non-capital loss, such losses must be used within the trust, either as a carry back to a previous year, or as a carry forward to a subsequent year. Note, however, that if the trust distributes capital assets with accrued losses, the fact that the transfer to a beneficiary is usually at the trust's tax cost means that such accrued losses can, in effect, be transferred to a beneficiary.

## Preferred Beneficiary Election

19-83. Normally a trust can only deduct amounts that are paid or payable to a beneficiary. An exception to this can arise if a joint election is made by a trust and a beneficiary. Under this preferred beneficiary election, the beneficiary will be taxed on amounts that remain in the trust [ITA 104(14)], and the trust can deduct these amounts [ITA 104(12)].

19-84. The preferred beneficiary election is only available if:

- the beneficiary is claiming the disability tax credit; or
- the beneficiary is 18 years of age or older, is claimed by another individual as a dependant, and does not have income that exceeds the base for the beneficiary's personal tax credit.
- In addition, the beneficiary must be the settlor of the trust, the spouse or former spouse of the settlor of the trust, or the child, grandchild, or great grandchild of the settlor of the trust, or the child, grandchild, or great grandchild of the spouse of the settlor of the trust.

19-85. This election is normally used in situations where it is desirable to have income taxed in the hands of a low income individual without actually giving that individual full access to the funds. An example of this would be a mentally disabled child with no other source of income, but lacking in the ability to deal responsibly with financial matters.

## Amounts Deemed Not Paid

19-86. Amounts paid or payable to a beneficiary are normally deducted by the trust and included in the income of the beneficiary. However, ITA 104(13.1) permits a trust to designate all or part of its income for a year as "not to have been paid" or "not to have become payable". The amounts so designated are not included in the beneficiaries' Net Income and are not deducted in computing the Net Income of the trust. As a result, the amounts are taxed in the trust and can be distributed tax free. This designation is only available to trusts that are resident in Canada throughout the taxation year and are subject to Part I tax.

19-87. Prior to 2016, when testamentary trusts had general access to graduated rates, this provision could be used advantageously when the trust had a lower marginal tax rate than the beneficiary. Except for graduated rate estates (GREs), this can no longer occur as other testamentary trusts are generally taxed at the maximum federal rate of 33 percent.

19-88. Prior to 2016, the amount deemed not paid provision could be used to avoid the instalment requirements that could be applicable to beneficiaries. While administratively the CRA no longer charges interest on late or insufficient instalments, instalments are required for all trusts other than graduated rate estates.

19-89. As previously noted, a trust cannot allocate losses to beneficiaries. This means that the only way that an unused current year trust loss can be utilized is through a carry over to another year. With many trusts, this cannot happen under normal circumstances because they are legally required to distribute all of their income to beneficiaries, resulting in a nil Net Income For Tax Purposes. A solution to this problem is to designate sufficient income as having not been paid to absorb the loss carry forward. This can satisfy the legal requirement to distribute the income, while simultaneously creating sufficient Net Income For Tax Purposes to absorb the loss carry forward. Although this feature is still available, the 2016 changes in trust legislation restrict the application of this provision so it can only be used to eliminate losses in the trust. It cannot be used to create a positive amount of income in the trust.

## Amounts Retained For A Beneficiary Under 21 Years Of Age

19-90. If benefits are actually paid to a minor beneficiary, the amounts can clearly be deducted by the trust. However, an adult settlor may decide that it would be better for the income to be held in trust until the beneficiary reaches some specified age. Provided the beneficiary has not reached 21 years of age prior to the end of the year, ITA 104(18) deems amounts that are retained to have become payable during the year. This means that the trust

will be able to deduct the amount retained and the beneficiary will be subject to taxes on it.

19-91. To qualify for this treatment, the amounts must be vested with the beneficiary and there cannot be any future condition that would prevent payment. When these amounts are eventually distributed, they will be received by the beneficiary on a tax free basis.

# Taxable Income Of A Trust

19-92. Once the Net Income For Tax Purposes of a trust is determined, calculation of Taxable Income involves the same deductions that would be available to individuals. Provided there is a positive Net Income For Tax Purposes, the trust can deduct non-capital losses of other years, net capital losses of other years, and farming and fishing losses of other years. The carry over periods for these losses that are applicable to individuals are equally applicable to trusts. Note that the ability to deduct net capital losses and restricted farm losses is dependent on having taxable capital gains or farm income included in the trust's Net Income For Tax Purposes for the current year.

### Exercise Nineteen - 5

**Subject:** Trust Net And Taxable Income

During the current year, the Jordan family trust, an inter vivos trust, has business income of $220,000. Of this amount, $50,000 is retained in the trust, with a joint election being made to have this amount taxed in the hands of a beneficiary who qualifies for the disability tax credit. This beneficiary has no other income. The remaining $170,000 is distributed to the other beneficiaries of the trust.

At the beginning of the current year, the trust had a business loss carry forward of $35,000. In order to make use of this loss, the trust designates an amount of $35,000 under ITA 104(13.1) as not having been paid during the year.

Determine the trust's Net Income For Tax Purposes and Taxable Income for the current year. Briefly explain why the trust would make the preferred beneficiary election and designate amounts not paid that were paid.

**SOLUTION available in print and online Study Guide.**

# Income Allocations To Beneficiaries

## General Rules

19-93. Since a trust is a separate taxable entity, any income that is earned by trust assets will initially accrue to the trust. As we have noted, however, any income that is allocated to a beneficiary can be deducted in the calculation of the trust's Net Income For Tax Purposes. Correspondingly, the amount deducted by the trust must generally be included in the Net Income For Tax Purposes of the relevant beneficiary. In effect, when trust income is allocated to a beneficiary, the obligation to pay taxes on that income is transferred from the trust to the beneficiary.

19-94. We have also noted that a trust can make payments to third parties for goods or services that will be provided to a beneficiary. These can include such expenses as day care, tuition, and medical fees. These amounts are deductible by the trust as allocations to beneficiaries, but will be considered income paid or payable to the beneficiaries.

19-95. For a trust to be able to deduct amounts that will be distributed to beneficiaries, the amounts must be paid or payable. While it is easy to determine whether an amount has been paid, questions often arise in determining whether or not an amount is payable to a beneficiary. ITA 104(24) provides that:

> ... an amount is deemed not to have become payable to a beneficiary in a taxation year unless it was paid in the year to the beneficiary or the beneficiary was entitled in the year to enforce payment of it.

19-96. Issuing a promissory note or a cheque payable to the beneficiary for the share of the trust income will usually fulfill the payable requirement. The CRA expands the definition of payable in IT-286R2 by stating that an amount is not considered to be payable in any of the following circumstances:

- A beneficiary can only enforce payment of an amount of income by forcing the trustee to wind up the trust.
- The beneficiary's right to income is subject to the approval of a third party.
- Payment of income is at the trustee's discretion and this provision has not been exercised.
- The beneficiary has the power to amend the trust deed and must do so to cause the income to be payable.

## Discretionary And Non-Discretionary Distributions

19-97. Both testamentary and inter vivos trusts can be set up as either discretionary or non-discretionary trusts. A discretionary trust is one in which the trustees are given the power to decide the amounts that will be allocated to each of the beneficiaries, usually on an annual basis.

19-98. In many cases, this discretionary power will apply only to annual income distributions. However, the trust could be structured to provide discretion on both income and capital distributions, or to capital distributions only. The trustees may also be given the power to control the timing of distributions to beneficiaries.

19-99. When discretionary trusts are used, it is important that only the amounts allocated to beneficiaries are considered to be paid or payable. If, for example, a trustee's exercise of discretion requires the approval of a third party, IT-286R2 would indicate that the amounts are not payable. This would result in the trust not being able to deduct the allocated amounts.

19-100. A non-discretionary trust is one in which the amounts and timing of allocations to income and capital beneficiaries are specified in the trust agreement. In some cases, the trust agreement may have a combination of discretionary and non-discretionary provisions.

## Flow Through Provisions

### General Applicability

19-101. Income that is paid out to beneficiaries through a trust is deemed to be property income unless there is a rule that says otherwise. Fortunately, there is a flow through rule that allows certain types of income paid out of a trust to retain the same tax characteristics as when it was earned in the personal trust. The most significant types of income covered by this flow through rule are capital gains, taxable dividends and capital dividends. Note that business income is not covered by the flow through rule. When business income is paid to beneficiaries, it is considered to be property income.

19-102. These flow through rules are an important feature of personal trusts in that capital gains and dividends are taxed much more favourably than other types of income. Since property income is fully taxed at an individual's regular rates, in the absence of such a flow through rule, in many instances the use of trusts would be much less attractive.

### Dividends

19-103. If either eligible or non-eligible dividends from taxable Canadian corporations are received by a trust and distributed to beneficiaries of the trust, the beneficiaries will use the same gross up and tax credit procedures that would be applicable had they received the dividends directly. At the trust level, these amounts will not be grossed up and the amount received and distributed will be deducted in the determination of the trust's Net Income.

19-104. In contrast, if either eligible or non-eligible dividends from taxable Canadian corporations are retained in the trust, the grossed up amount of these dividends will be

included in the trust's Net Income For Tax Purposes. Consistent with this, the trust will be able to deduct the appropriate dividend tax credit when it determines its Tax Payable for the year. Since capital dividends are tax free, they would have no effect on the trust's Tax Payable.

### Capital Gains

19-105. Under trust law, capital gains that are realized in the trusts are considered to be an addition to capital and, in the absence of a special provision in the trust agreement, would not be payable to income beneficiaries. However, tax legislation views one-half of capital gains as a taxable amount. As a consequence, if this amount is not paid out to beneficiaries, it will be taxed in the hands of the trust. The remaining one-half of the capital gain will become part of the trust's capital and can be paid to beneficiaries on a tax free basis at any point in time.

19-106. If the trust pays out the full amount of the capital gain, the flow through rule means that one-half of this amount will be included in the recipient's income as a taxable capital gain. The remaining one-half is received as a tax free distribution of capital.

19-107. It is important to note that the capital gains that we are discussing here are those that result from dispositions of trust property within the trust. As covered in Paragraph 19-69, if the trust distributes capital assets on which there are accrued capital gains, ITA 107(2) deems the transfer to be at the trust's tax cost resulting in no tax consequences to the trust. The accrued gains will not be subject to tax until the recipient beneficiary chooses to dispose of the assets that they have received.

### Tax On Split Income (TOSI)

19-108. As discussed in Chapter 11, as of 2018, individuals of any age may receive income that is subject to the TOSI. If the TOSI is applicable, tax will be assessed at the maximum federal rate of 33 percent on all such amounts, with the only available tax credits being the dividend tax credit and credits for foreign taxes assessed on foreign source income. We will not repeat the discussion of the applicability of TOSI in this Chapter.

19-109. However, the TOSI is very relevant in this Chapter because, if the trust earns income that would have been subject to the TOSI if it had been received directly by a beneficiary, it will also be subject to the TOSI if the trust distributes the income to that beneficiary. In other words, it will retain its character when it flows through the trust. Because of this, the income will be subject to the TOSI at 33 percent, the same rate that would be applicable to the trust.

## Exercise Nineteen - 6

**Subject:** Flow Through To Beneficiaries

During 2019, the Ho family trust received eligible dividends from publicly traded Canadian corporations in the amount of $100,000. In addition, it received non-eligible dividends from the family owned Canadian controlled private corporation in the amount of $30,000. Its only other source of income was a capital gain of $20,000 on a disposition of investments in publicly traded equity securities.

The only beneficiary of the trust is the family's 19 year old son, Bryan Ho. Bryan is actively engaged in the private corporation on a regular and continuous basis and, as a consequence, the TOSI is not applicable to the income that he receives from the trust.

During the current year, $60,000 of the eligible dividends from public companies, all of the non-eligible dividends from the family's private company, and all of the $20,000 capital gain were paid to Bryan.

Indicate the tax effects of these transactions on the Net Income For Tax Purposes for both the trust and for Bryan.

**SOLUTION available in print and online Study Guide.**

### *Business Income, CCA, Recapture, And Terminal Losses*

19-110. Under trust law, the amount of income that may be distributed to beneficiaries should be determined after providing for amortization expense calculated using methods similar to those specified under generally accepted accounting principles. While this could create a difference between a trust's accounting Net Income and its Net Income For Tax Purposes, this problem is resolved by most trustees by setting accounting amortization expense equal to maximum CCA.

19-111. Business income must be calculated at the trust level, prior to allocation to the beneficiaries. This calculation would include the CCA deduction, as well as any recapture or terminal losses that might arise during the year. As noted, the flow through rule for trusts does not cover business income. This means that any business income allocated to beneficiaries is distributed to them as property income. If this was not the case, business income flowed through a trust could create a liability for CPP and GST/HST which would complicate matters for many beneficiaries.

**Exercise Nineteen - 7**

**Subject:** CCA And Recapture On Trust Assets

The Husak family trust has only one beneficiary, Martin Husak, the 32 year old son of the settlor, Dimitri Husak. It is an inter vivos trust and its only asset is a rental property with a fair market value equal to its capital cost. The trust is required to distribute all of its income to Martin. During the year ending December 31, 2019 the property will have net rental income, before the deduction of CCA, of $32,000. Maximum CCA for the year will be $26,000.

Dimitri is considering having the trust sell the rental property at the end of 2019. If that is done, there will be recapture of CCA of $65,000. He has asked you to compare the tax consequences for both Martin and the trust if (1) the sale takes place in December, 2019 and (2) the trust continues to hold the property.

Ignore the possibility that some of the income received might be subject to the TOSI.

**SOLUTION available in print and online Study Guide.**

## Principal Residence Exemption

19-112. Prior to 2017, a residence held in a trust that was ordinarily inhabited by a beneficiary of the trust, or by a spouse or common-law partner, former spouse or common-law partner, or a child of a beneficiary, was eligible for the principal residence exemption (see Chapter 8). This is no longer the case. For years ending after 2016, only alter ego trusts, joint partner trusts, spousal or common-law partner trusts, qualified disability trusts, or a qualifying trust for a minor child will be able to use this exemption to eliminate or reduce any capital gain resulting from the sale of a residence held in the trust. If such gains arise in other types of trusts, they will be subject to the usual capital gains taxation.

# Tax Payable Of Personal Trusts

## Calculation Of Basic Amount

### *General Approach*

19-113. In keeping with the previously expressed idea that trusts are to be taxed in the same manner as individuals, the Tax Payable for a trust is calculated using the rates applicable to individuals. However, how these rates will be applied differs, depending on whether the trust is an inter vivos trust or a regular testamentary trust, or, alternatively, a graduated rate estate. These differences will be discussed in the material that follows.

### Graduated Rate Estates

19-114. As discussed previously, in the first T3 filed subsequent to an individual's death, trust assets that are still under the administration of an executor can be designated a Graduated Rate Estate. You will recall that this designation can remain in effect for up to 36 months subsequent to the death of the individual.

19-115. The major benefit resulting from this designation is that, during the period in which the designation is in effect, the trust can calculate Tax Payable using the graduated rate schedule that is applicable to individuals. As described in Chapter 4, for 2019, the federal tax rates range from 15 percent on the first $47,630 of Taxable Income to 33 percent on amounts in excess of $210,371.

### Inter Vivos Trusts And Regular Testamentary Trusts

19-116. Under ITA 122(1), all of the income of an inter vivos trust is assessed tax at the highest federal rate applicable to individuals, 33 percent.

19-117. Prior to 2016, all testamentary trusts used the same schedule of graduated rates and income brackets that was applicable to individuals. However, due to the major overhaul of taxation for testamentary trusts, beginning in 2016 testamentary trusts other than graduated rate estates and qualified disability trusts will have all of their taxable income subject to the maximum tax rate of 33 percent. This means that inter vivos trusts and regular testamentary trusts are now taxed in a similar manner.

### Multiple Testamentary Trusts

19-118. Prior to 2016, it was not uncommon for an individual to establish multiple testamentary trusts, usually on the basis of a separate trust for each beneficiary of the individual's estate. This could be very advantageous in that there could be multiple applications of the graduated rate structure. For example, if there were three different testamentary trusts, each trust could benefit from the lowest rate of 15 percent.

19-119. This tax advantage is no longer available. In general, testamentary trusts will have all of their income taxed at the maximum 33 percent federal rate. While a Graduated Rate Estate can still use graduated rates, there can only be one such trust and its life is limited to 36 months.

### Tainted Testamentary Trusts

19-120. Contributions by living persons to an existing testamentary trust can cause that trust to become tainted and lose its testamentary status. It will then be treated as an inter vivos trust. Prior to 2016, this could have had significant tax effects. Currently, the only trusts not federally taxed at 33 percent are Graduated Rate Estates. The only property that can be included in a Graduated Rate Estate is the property that was owned by the decedent at the time of death. It would not be possible to make additions to this balance.

## Other Tax Payable Considerations

### Availability Of Tax Credits

19-121. While, in principle, trusts are to be taxed in the same manner as individuals, there are obvious differences between a legally constructed entity and a living, breathing human being. These differences are reflected in the fact that trusts are not eligible for many of the tax credits that are available to individuals.

19-122. To begin, ITA 122(1.1) specifically prohibits a trust from claiming any of the credits listed under ITA 118 (personal tax credits). Further, most of the other credits listed in ITA 118.1 through 118.9 are clearly directed at individuals (e.g., a trust is not likely to have medical expenses). However, some tax credits are available to trusts, generally on the same basis as they are available to individuals. These include:

- donations and gifts (As is the case with individuals, there is a credit of 15 percent on the first $200 of donations and either 29 percent or 33 percent on additional amounts.)
- eligible and non-eligible dividend tax credits
- foreign tax credits
- investment tax credits

### Alternative Minimum Tax

19-123. As is the case with individuals, trusts are subject to the alternative minimum tax legislation. However, there is one important difference. With the exception of Graduated Rate Estates, the exemption with respect to the first $40,000 of income is not available to trusts.

### Tax Free Dividends

19-124. Because dividends use up available tax credits at a much slower pace than other types of income, individuals can receive a substantial amount of dividends on a tax free basis. As explained in Chapter 15, this only works when income is taxed at the two lowest federal rates of 15 percent and 20.5 percent. As we have indicated, both inter vivos and most testamentary trusts are taxed at 33 percent on all of their income. When this is the case, the trust cannot receive any dividends on a tax free basis.

19-125. However, Graduated Rate Estates can receive tax free dividends. For example, if such a trust has no other source of income, it can receive up to $30,319 in eligible dividends without paying any taxes.

**Exercise Nineteen - 8**

**Subject:** Tax Payable On Trust Dividends

A trust receives $100,000 in eligible dividends. This is the trust's only income for the current year. The only beneficiary of the trust is the settlor's 32 year old son. The son has no income other than that provided by the trust and no tax credits other than his basic personal credit and credits related to any trust income. Ignoring any alternative minimum tax implications, determine the Taxable Income and federal Tax Payable for both the trust and beneficiary under the following alternative assumptions:

A. The trust is a Graduated Rate Estate and it distributes all of the dividends to the beneficiary. Assume that the TOSI would not be applicable to the dividends received by the settlor's son.

B. The trust is a Graduated Rate Estate and it does not distribute any of the dividends to the beneficiary.

C. The trust is an inter vivos trust and does not distribute any of the dividends to the beneficiary.

**SOLUTION available in print and online Study Guide.**

**We suggest you work Self Study Problems Nineteen-2, 3, and 4 at this point.**

# Income Attribution - Trusts

## General Rules

19-126. We introduced the income attribution rules for individuals in Chapter 9. Briefly summarized, they are as follows:

**Transfer To A Spouse Or Common-Law Partner** Under ITA 74.1(1), if an asset is transferred to a spouse or common-law partner for consideration that is less than fair market value, any property income earned by the asset while it is held by that person, as well as any capital gain resulting from a disposition of the asset by the transferee, will be attributed back to the transferor. These rules also apply, without regard to the value of the consideration, when the transferor does not elect out of the ITA 73 rollover provision.

**Transfer To A Related Minor** Under ITA 74.1(2), if an asset is transferred to a related individual under the age of 18 for consideration that is less than fair market value, property income earned by the asset while it is held by the minor will be attributed back to the transferor until the year the individual is 18 or older. Capital gains on a subsequent sale of the asset will not be attributed back to the transferor.

We would remind you that, if the transferred property is a business, business income is not subject to the income attribution rules. Also, the rules do not apply any income that is classified as Split Income.

19-127. While we did not discuss this point in Chapter 9, these rules are equally applicable when there is a transfer to an inter vivos trust where a spouse, common-law partner, or a related minor is a beneficiary. As was the case with individuals, these rules apply to any transfer where the consideration is less than the fair market value of the asset transferred.

19-128. You should note that attribution does not occur at the time the asset is transferred to a trust in which a spouse, common-law partner, or related minor is a beneficiary. Rather, attribution occurs when income from the asset is allocated to one of these individuals. If the trust chooses to be taxed on the income before allocation, or if the income is allocated to individuals other than a spouse, common-law partner, or related minor, income will generally not be attributed to the transferor. In addition, income attribution stops at the death of the settlor.

**Exercise Nineteen - 9**

**Subject:** Income Attribution - Trusts

Last year, Trevor Carlisle transferred to a family trust, for no consideration, bonds that pay interest of $27,000 per annum. The beneficiaries of the trust are Trevor's spouse, Carmen, and their two children, Mitch (16 years old) and Rhonda (22 years old). The beneficiaries have no income other than that from the trust. The trust income and capital gains are allocated equally, and are payable to each beneficiary during the year. Total interest income earned by the trust during the year was $27,000. As well, a capital gain of $6,000 was realized on the trust's disposition of one of the bonds that Trevor transferred into the trust. Determine the Taxable Income of each beneficiary and calculate any effect the trust income will have on the Taxable Income of Trevor. How would your answer change if Trevor died on January 1 of the current year?

Ignore the possibility that some of the income received by the beneficiaries will be subject to the TOSI.

**SOLUTION available in print and online Study Guide.**

**We suggest you work Self Study Problems Nineteen-5 and 6 at this point.**

## Attribution To Settlor (Reversionary Trust)

19-129. There is a further form of income attribution that is unique to trust situations. Both income from holding the transferred property and capital gains from the disposition of the transferred property will be attributed back to the settlor if a trust meets the conditions specified in ITA 75(2).

19-130. ITA 75(2) is applicable, without regard to the identity of the beneficiaries of the trust, if any one of the following conditions is satisfied:

1. The transferred property can revert to the settlor at a later point in time. In this situation, the trust is commonly referred to as a reversionary trust.
2. The transferred property will pass to persons to be determined by the settlor at a later point in time. This requirement prevents the settlor from adding additional beneficiaries, or classes of beneficiaries, subsequent to the creation of the trust.
3. The transferred property cannot be disposed of except with the settlor's consent or in accordance with the settlor's direction.

19-131. The safest way to deal with the second condition is to not have the settlor act as a trustee. If that is not a practical alternative, it would be prudent to have at least three trustees and have majority approval of decisions. If the settlor is one of two trustees or, if decisions require unanimous approval by all trustees including the settlor, ITA 75(2) may apply.

# Purchase Or Sale Of An Interest In A Trust

## Income Interest

19-132. An income interest in a trust is the right of a beneficiary under the trust to receive all or part of the income from the trust. The purchaser of an income interest in a trust will have a cost equal to the fair market value of the consideration given for that interest. This cost can be deducted against amounts of trust income that would otherwise be included in the individual's Taxable Income. Any portion of the cost that is not deducted against income from the trust in the current year can be carried forward for deduction against allocated trust income in subsequent years. When income allocations have reduced the cost of the interest to nil, subsequent receipts of income will be fully taxable.

19-133. From the point of view of the vendor of an income interest, the proceeds of disposition will be equal to the fair market value of the consideration received. If the cost of the income interest (often nil) is different than the proceeds received, there will be a gain or loss on the disposition. As an income interest is not a capital asset, the gain or loss on its disposition will be treated as a fully taxable or deductible property income or loss.

## Capital Interest

19-134. As defined in ITA 108(1), a capital interest is all of the rights of a beneficiary of a trust, other than an income interest. As the name implies, a capital interest is a capital asset and any gain or loss on its disposition will be treated as a capital gain or loss.

19-135. When a capital interest in a trust is purchased, the adjusted cost base is equal to the fair market value of the consideration given. This amount will be reduced by future distributions of assets from the trust. As we have noted, ITA 107(2) generally provides for a tax free rollover of assets from a trust to a beneficiary.

19-136. If a beneficiary sells a capital interest in a trust, the proceeds of disposition will equal the fair market value of the consideration received. Unless the taxpayer has purchased the capital interest, its adjusted cost base will be nil. This means that the entire proceeds of disposition could be a capital gain. However, to determine the gain on a disposition of a capital interest in a trust resident in Canada, ITA 107(1)(a) defines the adjusted cost base to be the greater of:

- the adjusted cost base as usually determined, and
- the "cost amount" to the beneficiary.

19-137. ITA 108(1) defines this cost amount as the beneficiary's proportionate interest in the net assets of the trust at their carrying value to the trust. This prevents the beneficiary from being taxed on the cost amount of the trust's assets, an amount that could be received on a tax free basis as a distribution from the trust. Capital losses on capital interest dispositions are

determined in the usual manner. Since the adjusted cost base is usually nil, such losses are uncommon.

## Exercise Nineteen - 10

**Subject:** Sale Of A Capital Interest

The Jardhu family trust was established when the father transferred publicly traded securities with a cost of $120,000 and a fair market value of $250,000 into the trust. The beneficiaries of the trust are the father's two sons, Sam, aged 25 and Mehrdad, aged 27. They have an equal interest in the income and capital of the trust.

At the beginning of the current year, Mehrdad sells his capital interest in the trust to Sam. There have been no capital distributions from the trust. At the time of the sale, the fair market value of the securities in the trust is $380,000. Based on this, the transfer price for the capital interest is $190,000 [(1/2)($380,000)]. Determine the tax consequences of this transaction to each of the two brothers.

**SOLUTION available in print and online Study Guide.**

# Tax Planning

## Family Trusts

### *Defined*

19-138. As we have noted, the term family trust is not defined in the *Income Tax Act*. Rather, it is a term that is used in practice to refer to a personal trust that has been established with members of the settlor's family as beneficiaries. These trusts can either be inter vivos trusts established during the settlor's lifetime or, alternatively, testamentary trusts created when the settlor dies. The provisions of these trusts often contain a fixed arrangement for the payments to beneficiaries. However, in some cases they are established with the payments to the beneficiaries left to the discretion of the trustees.

19-139. While family trusts can be used for a variety of purposes, the most common objective of these trusts is income splitting. This process was introduced in Chapter 1, with further elaboration on the role of corporate structures in income splitting discussed in Chapter 15. In this Chapter we will give attention to income splitting in the context of family trusts. As we have noted, the expansion of the TOSI to related adults makes it much more difficult to implement effective income splitting strategies.

### *Discretionary Trusts*

19-140. As we have noted, a family trust is usually established for income splitting purposes, typically by a wealthy individual with children or other family members who are in low tax brackets. Such individuals commonly have difficulty deciding which of their family members are, and will continue to be, the most deserving. A solution to this problem is the use of a discretionary trust.

19-141. The provisions of discretionary trusts leave the amount and/or timing of payments to beneficiaries at the discretion of the trustees. This means that, if a particular beneficiary neglects his family duties on a regular basis, or appears to be profligate in his spending habits, his share of the income can be reduced, eliminated, or delayed to a later date. Tax planners like to point out that this provides the settlor with great flexibility. A less charitable view of the settlor's objectives is that this type of arrangement provides for continued control over the behaviour of family members (e.g., if a child fails to show up for family dinners, he can be reminded that his receipts from the family trust are discretionary).

19-142. It is important to note that the settlor of the trust cannot be in a position of unilateral control over the amount and timing of the discretionary distributions, particularly if he is also one of the beneficiaries. If the settlor is in a position of control, the provisions of ITA 75(2) (see Paragraph 19-130) may be applicable, resulting in all of the income being attributed back to him. The usual way to avoid this problem is to have at least three trustees, with the amount of the discretionary distributions determined by majority rule. The CRA has indicated that, for this approach to be effective, the settlor cannot be a required part of the majority.

## Income Splitting

19-143. If a family trust is set up properly, the potential tax savings from income splitting can be significant. The following table compares the federal Tax Payable on eligible dividends of $58,566 received by:

- A father who is subject to the maximum federal tax rate of 33 percent.
- His adult daughter with no other source of income. Assume that any income distributed to the daughter will not be subject to the TOSI.

19-144. The required calculations follow. Note that, given the amounts and type of income involved in this example, the application of the alternative minimum tax (AMT) reduces the amount of the tax savings to some degree.

| | Father | Daughter | AMT (Daughter) |
|---|---|---|---|
| Eligible Dividends Received | $58,566 | $58,566 | $58,566 |
| Gross Up At 38 Percent | 22,255 | 22,255 | N/A For AMT |
| Taxable Dividends/Income | $80,821 | $80,821 | $58,566 |
| Federal Tax | | | |
| [(33%)($80,821)] | $26,671 | | |
| [(15%)($47,630) + (20.5%)($33,191)] | | $13,949 | |
| [(15%)($58,566 - $40,000 Exemption)] | | | $ 2,785 |
| Federal Dividend Tax Credit | | | |
| [(6/11)($22,255)] | ( 12,139) | ( 12,139) | N/A For AMT |
| Basic Personal Credit (Note) | N/A | ( 1,810) | ( 1,810) |
| Federal Tax Payable/AMT | $14,532 | Nil | $ 975 |

**NOTE** Since the father would have other income against which he could apply his basic personal credit, it has not been taken into consideration in the preceding calculations.

19-145. This example is designed to use the maximum of tax free eligible dividends that can be paid to an individual with only the basic personal tax credit. As shown in the preceding calculations, this serves to reduce the daughter's regular Tax Payable to nil. However, AMT will be payable, resulting in a net tax savings through the use of a family trust in the amount of $13,557 ($14,532 - $975). The corresponding savings in provincial taxes would increase this amount significantly. Note that this tax savings would be available for each beneficiary if there were multiple beneficiaries. Of equal importance is the fact that this is not a one time event. These tax savings can be accomplished on an annual basis as long as the beneficiaries have no other source of income.

19-146. You should note that, in situations where the beneficiary will be subject to the TOSI, it would be difficult, if not impossible to achieve substantial or, in fact any, tax savings through the use of this tax planning vehicle.

## Exercise Nineteen - 11

**Subject:** Family Trusts

Sarah Block is holding debt securities which produce interest income of $110,000 per year. She has other sources of income in excess of $250,000. She has two children. Her daughter, Jerri, is 22 years old and currently has no income that is subject to tax. Jerri's only tax credit is the basic personal credit. Sarah's son, Mark, is 26 years old. He is married and his wife has no income of her own. Mark has annual net rental income of $48,000.

The trust will be required to distribute all of its income on an annual basis. Determine the savings in federal taxes that could be achieved by transferring the debt securities to a family trust with her two children as equal income beneficiaries.

Assume that Mark's only tax credits are the basic personal credit and the spousal credit and that none of the income received by the beneficiaries will be subject to the TOSI.

**SOLUTION available in print and online Study Guide.**

## Qualifying Spousal Or Common-Law Partner Trusts

19-147. As is discussed in Chapter 9, a rollover of assets to a spouse can be accomplished without the use of a trust. In the case of a living individual, the rollover is provided for under ITA 73(1) and (1.01), while for a deceased individual, the enabling provision is ITA 70(6). This makes it clear that a trust is not required to implement a tax free transfer of property for the benefit of a spouse. Why then are we concerned with qualifying spousal or common-law partner trusts? There are essentially two important reasons:

1. A trust can provide for the appropriate management of the transferred assets, particularly when these assets include an active business. In many cases, the spouse or common-law partner of a settlor may have no experience in the management of assets and, in such situations, the trust document can ensure that professional management is used. If the assets were simply transferred to the spouse or common-law partner, the use of such management would be left to the discretion and control of the transferee.
2. Also of importance is that the use of a trust can ensure that the assets are distributed in the manner desired by the settlor. While qualification requires that the transferred assets must "vest indefeasibly" with the spouse or common-law partner, the trust document can specify who the assets should be distributed to after the spouse or common-law partner dies. This could ensure, for example, that the assets are ultimately distributed only to the settlor's children if the spouse or common-law partner was to remarry and have additional children.

## Alter Ego Trusts

19-148. The most commonly cited reason for using an alter ego trust is that the trust property will not be included in the settlor's estate and, as a consequence, will not be subject to probate procedures (probate is a court process that proves the authenticity and validity of a will). There are a number of advantages associated with avoiding probate:

- The probate fees can be high. In Ontario, for example, they are equal to 0.5 percent on the first $50,000 of the fair market value of the estate, plus 1.5 percent of the excess, with no upper limit. On a $10 million estate these fees would total almost $150,000, a payment that can be completely eliminated with the use of an alter ego trust.

- The probate process can be time consuming. This can create difficulties for the management of an active business, as well as liquidity problems for the estate.
- When assets such as real estate are held in more than one jurisdiction (e.g., Canada and the U.S.), the probate procedures must be undertaken in multiple jurisdictions.
- Once probated, a will is in the public domain. For a nominal fee, any interested individual can obtain a copy, with the possibility that this will invade the privacy of surviving family members.

19-149. While this point has not been widely discussed in the literature that we have seen on this subject, an additional tax feature involved in establishing an alter ego trust is the possibility of establishing the trust in a low tax rate province. When there is a deemed disposition at death or on emigration, the taxation will occur in the province where the trust is resident. Given that, for 2019, the combined federal/provincial rate on individuals ranges from 47.5 in Saskatchewan, to 54 percent in Nova Scotia, this 6.5 percentage point difference makes the province of residence of the trust a significant tax planning issue.

19-150. We would also note that there is a significant non-tax reason for using an alter ego trust. From a legal point of view, it is much easier to challenge the validity of a will than it is to challenge the validity of a trust. Courts can be asked to consider moral obligations to family members in distributing the assets of an estate. With a trust, there is no will to challenge.

### Joint Spousal Or Joint Common-Law Partner Trusts

19-151. A joint spousal or joint common-law partner trust has the same tax characteristics as an alter ego trust. The basic difference is that these trusts are established to hold the combined assets of both an individual and his spouse or common-law partner. Given this, their tax planning features are largely the same as those discussed for alter ego trusts in the preceding Paragraphs.

## Estate Planning

### Non-Tax Considerations

19-152. The subject of estate planning is complex and involves considerations that go well beyond the scope of this text. In fact, appropriate planning for a large estate will often involve lawyers, investment advisors, accountants, and tax advisors. Indeed, it may even be necessary to have religious advisors or psychological counselors participate in order to deal with some of the moral or emotional issues that are involved.

19-153. The following points are among the more important non-tax considerations in planning an estate:

**Intent Of The Testator** The foremost goal of estate planning is to ensure that the wishes of the testator (a person who has died and left a will) are carried out. This will involve ensuring that the assets left by the testator are distributed at the appropriate times and to the specified beneficiaries. The primary document for ensuring that the intent of the testator is fulfilled is, of course, the will.

**Preparation Of A Final Will** The major document in the estate planning process is the final will. It should be carefully prepared to provide detailed instructions for the disposition of assets, investment decisions to be made, and the extent to which trusts will be used. An executor should be named to administer the estate, and the will should be reviewed periodically to ensure that it reflects the testator's current wishes and family status.

**Preparation Of A Living Will** Equally important to the preparation of a final will, a living will provides detailed instructions regarding investments and other personal decisions in the event of physical or mental incapacity at any point in a person's lifetime. A power of attorney is similar, except that it does not require the individual to be mentally or physically incapacitated in order to be used.

**Ensuring Liquidity** A plan should be established to provide for liquidity at the time of death. Major expenses, often including funeral expenses and income taxes, will arise at this time. Funds needed for these payments should be available, or adequate life insurance should be arranged in advance, to avoid the need for emergency sales of capital assets to raise the necessary cash.

**Simplicity** While the disposition of a large estate will rarely be simple, effective estate planning should ensure that the plan can be understood by the testator and all beneficiaries of legal age. In addition, any actions that can reduce the cost and complexity of administering the estate should be considered. This might involve disposing of investments in non-public shares, or repatriating assets that are located in foreign countries that might become subject to foreign taxation.

**Avoidance Of Family Disputes** Unfortunately, disputes among beneficiaries are a common part of estate settlement procedures. If equitable treatment of beneficiaries is a goal of the testator, efforts should be made to ensure that all beneficiaries believe that they have been treated in an equitable manner. If the testator wants to distribute assets in a fashion that could be viewed as inequitable by any of the interested parties, care should be taken to make this intention unequivocal.

**Expediting The Transition** The procedures required in the settlement of an estate should be designed to expedite the process. A long settlement period can increase uncertainties related to the value of assets, add to the complications associated with the required distribution of the assets, and prolong the frustration of the beneficiaries.

## Tax Considerations

19-154. In addition to the preceding non-tax considerations, estate planning must also consider various tax factors. Fundamental tax planning goals for all taxpayers apply equally to estate planning. Briefly, these goals involve the legal and orderly arrangement of one's affairs, before the time of a transaction or event, to reduce and defer income taxes.

19-155. In effective estate planning, the overriding income tax goals are to defer and minimize tax payments. Several important issues should be considered in dealing with this objective. These can be described as follows:

**Prior To Death** Planning should attempt to minimize taxes for the individual in the years prior to death. If the individual earns income that is not required in these years, attempts should be made to defer the payment of tax and transfer the before-tax income to the ultimate beneficiaries. The use of a discretionary trust can assist in achieving this goal.

**Year Of Death** Planning should attempt to minimize income taxes payable in the year of death. Deemed dispositions will occur at death and, in addition, amounts in certain types of deferred income plans usually must be included in the taxpayer's final return. Relief can be achieved through tax deferred rollovers to a spouse and transfers of certain types of property (e.g., farm property) to children or grandchildren. The will can also contain instructions to ensure that the maximum RRSP contribution is made to the spouse's RRSP within the deadline.

**Income Splitting** Effective planning should allow income splitting among family members who are in lower tax brackets. This can be accomplished by the appropriate splitting of income (e.g., paying salaries and wages for services rendered) and distributing property among beneficiaries throughout a taxpayer's lifetime, recognizing the limitations imposed by the TOSI.

**Foreign Jurisdictions** Planning should normally attempt to minimize taxes that will be incurred in foreign jurisdictions. This is especially true for jurisdictions with significant estate taxes as such taxes are generally not eligible for foreign tax credits or deduction in Canada. To the extent that it is consistent with the individual's investment plans and the residence of intended beneficiaries, holdings of foreign assets at

death, or distributions to beneficiaries in foreign locations, should usually be avoided by residents of Canada. Minimizing foreign investments will also simplify the administration of an estate.

**Administration Period** Planning should minimize taxes payable while the estate is being administered. Discretion provided to trustees in distributing the income of an inter vivos trust may assist in achieving this goal.

19-156. Most of the tax procedures related to these issues have already been introduced. We have discussed spouse and common-law partner rollovers in previous Chapters and the use of trusts was covered earlier in this Chapter. An important aspect of estate planning that requires additional consideration is the estate freeze. Procedures to be used in these arrangements are outlined in the material that follows.

# Estate Freeze

## Objectives Of An Estate Freeze

19-157. The objective of an estate freeze is, as the name implies, to freeze the value of the estate for tax purposes at a particular point in time. Typically, arrangements are made for all future appreciation to accrue to related parties such as a spouse, children, or grandchildren.

**EXAMPLE** Mr. Chisholm is a wealthy and successful entrepreneur who has a wife and two young children. He owns a variety of capital assets that are producing Taxable Income and appreciating in value. He has several objectives in creating his estate plan:

- During the remainder of his life, Mr. Chisholm would like to transfer all or part of his Taxable Income to a group of individuals and charities who will ultimately be the beneficiaries of his estate.
- Mr. Chisholm would like to freeze the tax values of his assets and allow future growth to accrue to the intended family members.
- Since the current fair market value of his assets exceeds their tax cost, Mr. Chisholm would like to avoid any immediate taxation resulting from a disposition of these assets with accrued gains.
- Mr. Chisholm would like the transfer of future growth in asset values to accrue so that his beneficiaries will not be subject to taxation in the year of the estate freeze, in any intervening years, or in the year of his death.
- Mr. Chisholm wants to retain the right to the current value of the property at the time of the estate freeze. In addition, he wishes to retain control of the use of the property until his death.

19-158. This example will be used as a basis for discussing a variety of techniques that can be used to freeze an estate's value. Some of these techniques will achieve all of Mr. Chisholm's goals, while others will only succeed in achieving one or two of them.

## Techniques Not Involving Rollovers

### Gifts

19-159. Mr. Chisholm can freeze the value of his estate without using rollover provisions. The most straightforward technique is to simply give property to his prospective beneficiaries. While this would accomplish the goal of transferring future growth in the estate to the beneficiaries, unless the transfer was to a spouse or common-law partner, this approach would have the serious drawback of attracting immediate taxation on any difference between the fair market value of the assets and Mr. Chisholm's tax cost.

19-160. In addition, if the person receiving the gift is a spouse or minor child, income attribution rules could apply after the gift is made. Further drawbacks are the fact that Mr.

Chisholm would lose control over the assets and that certain income received by related persons may be subject to the TOSI.

19-161. While gifts result in a loss of control, Mr. Chisholm may want to accelerate his donations to registered charities. The value of the tax credit associated with such gifts can more than offset any income arising as the result of such distributions. In particular, if a gift is made of shares listed on a designated stock exchange, the capital gains inclusion rate is reduced to nil (See Chapter 11).

### Instalment Sales

19-162. Mr. Chisholm could freeze the value of the estate by selling the assets to the intended family members on an instalment basis. Capital gains could be deferred until payment is received, but the gains would need to be reported over the next 5 years based on the capital gains reserve calculations (10 years if a farm or fishing property is involved).

19-163. To avoid income attribution and inadequate consideration problems, the sale should be made at fair market value. However, if the intended family members do not have sufficient assets to make the purchase, this may not be a feasible solution. A further problem is that Mr. Chisholm would lose control over the property.

### Establishing A Trust

19-164. An estate freeze can also be accomplished by setting up a trust in favour of one or more beneficiaries. Here again, this will transfer income and future growth from Mr. Chisholm's hands to the trust. The trust can be structured so that he retains some control over the assets in the trust.

19-165. The problem with this arrangement is that, except in the case of a qualifying spouse or common-law partner trust, a joint spousal or common-law partner trust, or an alter ego trust, there is no rollover provision that provides for tax deferred transfers of assets to a trust. As a result, if the trust is set up for beneficiaries other than Mr. Chisholm or his spouse, Mr. Chisholm will incur taxation on any capital gains accrued at the time of the transfer. As well, any dividends received from a private corporation by related beneficiaries may be subject to the TOSI, whether the shares are held directly or through a trust.

### Use Of A Holding Company

19-166. Mr. Chisholm could transfer assets to a holding company in which intended family members have a substantial equity interest, without using a rollover provision. This will freeze the value of his estate and, if the assets transferred have fair market values that are equal to or less than their adjusted cost base, it can be an effective vehicle for realizing losses. However, without the use of a rollover provision, such as that found in ITA 85, any capital gains or recapture amounts that have accrued to the time of the transfer will become subject to immediate taxation.

## Section 86 Share Exchange

### Nature Of The Exchange

19-167. Chapter 17 provided an overview of ITA 86 which applies to the exchange of shares by a shareholder in the course of a reorganization of capital. In certain situations, a share exchange constitutes the best solution to the estate freeze problem. Specifically, this rollover is most appropriate in a situation that involves an individual who is the sole owner of a successful private corporation.

19-168. By exchanging common shares for preferred shares that have equal value, the owner will, in effect, eliminate his participation in the future growth of the company. At the same time, common shares can be issued to intended family members or a discretionary family trust created for their benefit. These new shareholders can participate in the company's future income and any growth in the value of its assets.

### Example

19-169. While detailed consideration was given to ITA 86 rollovers in Chapter 17, the following simple example will serve to review these procedures.

**EXAMPLE** Over her lifetime, Mrs. Hadley has been the sole owner and driving force behind Hadley Inc., a manufacturing business located in Alberta. At the end of the current year, the condensed Balance Sheet of this Company was as follows:

**Hadley Inc.**
**Balance Sheet**

| | |
|---|---|
| Net Identifiable Assets | $10,000,000 |
| Common Stock (No Par - 1,000 Shares) | $ 2,000,000 |
| Retained Earnings | 8,000,000 |
| Total Shareholders' Equity | $10,000,000 |

On the basis of an independent appraisal, the fair market value of this business was established at $15,000,000. Mrs. Hadley has a husband and three adult children and would like them to share equally in her estate. The $2,000,000 Common Stock account is both the adjusted cost base and the PUC of her shares.

19-170. Under ITA 86, Mrs. Hadley can exchange, on a tax deferred basis, her common shares that have an adjusted cost base of $2 million (also the amount of contributed capital and PUC) for preferred shares with a redemption value of $15 million (the fair market value of the business). These preferred shares would have no participation in the future growth of the Company and, as a result, Mrs. Hadley has effectively frozen the value of her estate.

19-171. If Mrs. Hadley wishes to retain control of the Company, the preferred shares can be established as the only outstanding voting shares. While this share exchange will be free of any capital gains taxation, Mrs. Hadley's adjusted cost base and PUC for the new preferred shares remains at the former common share value of $2 million. If the preferred shares are sold for their market value of $15 million, a $13 million capital gain will result ($15 million - $2 million). Alternatively, if the shares are redeemed for $15 million by the Company, there will be a $13 million taxable dividend under ITA 84(3).

19-172. The tax cost basis for the identifiable assets owned by the Company has not been altered by the share exchange transaction.

19-173. At this point, the redemption value of Mrs. Hadley's preferred shares represents he entire fair market value of the business and, as a consequence, the value of any common shares issued will not exceed the amount contributed by the investors. This means that such shares can be issued for a nominal value, without any appearance that the purchasers are indirectly receiving a gift from Mrs. Hadley. Thus, 1,000 common shares could be issued to Mrs. Hadley's intended family members at $10 per share as follows:

| | |
|---|---|
| Spouse (250 Shares At $10) | $ 2,500 |
| Child One (250 Shares At $10) | 2,500 |
| Child Two (250 Shares At $10) | 2,500 |
| Child Three (250 Shares At $10) | 2,500 |
| Total Common Stock Contributed | $10,000 |

19-174. These common shares would benefit from the future income and growth in asset values that may be experienced by Hadley Inc.

19-175. Prior to 2018, this Section 86 rollover would have provided an ideal solution to the estate freeze problem. It did, in fact, transfer all future growth in the estate into the hands of intended beneficiaries with no immediate tax effects on the individual making the transfer. However, there is a problem in that, with the new TOSI rules in place, income received by the family members is likely to be taxed at the maximum federal rate of 33 percent.

### Rollover Provisions - Section 85 vs. Section 86

19-176. A Section 85 rollover of property to a holding corporation can also be used to implement an estate freeze. The rollover provisions of ITA 85 were given full consideration in Chapter 16, and will not be repeated here.

19-177. In comparing the use of ITA 85 and ITA 86, you should note that Section 85 can be used in a broader variety of circumstances than is the case with Section 86. More specifically, Section 86 deals only with exchanges of shares in the course of the reorganization of an existing corporation. This means that Section 86 can only be used in situations where the assets involved in the estate freeze are shares of a corporation. Section 85 would have to be used if the estate consists of other types of property.

19-178. When Section 86 can be used, it is an easier procedure to implement. Unlike Section 85, which requires a formal election to be made and either an existing corporation or the formation of a new corporation, Section 86 applies automatically once the required conditions are met. By using a Section 86 reorganization, the savings in legal and accounting fees can be significant. The many complexities involved in effecting an estate freeze using rollovers make it difficult to comment on the relative desirability of Sections 85 and 86 for estate freezes in general terms.

## SIFT Partnerships And Trusts

19-179. As was noted in Chapter 18, legislation has served to largely eliminate SIFT partnerships and trusts. Given this, we do not provide coverage of this subject in *Canadian Tax Principles*, except in Chapter 7, Property Income, where we have limited coverage of real estate income trusts (REITs).

**Additional Supplementary Self Study Problems Are Available Online.**

## Key Terms Used In This Chapter

19-180. The following is a list of the key terms used in this Chapter. These terms, and their meanings, are compiled in the Glossary located at the back of the Study Guide.

Alter Ego Trust
Beneficiary
Capital Interest (In A Trust)
Discretionary Trust
Estate
Estate Freeze
Executor
Family Trust
Graduated Rate Estate
Income Attribution
Income Interest (In A Trust)
Income Splitting
Inter Vivos Trust
Joint Spousal Or Common-Law Partner Trust
Non-Discretionary Trust
Personal Trust
Preferred Beneficiary
Preferred Beneficiary Election
Qualifying Spousal or Common-Law Partner Trust
Reorganization Of Capital (ITA 86)
Reversionary Trust
Rollover
Settlor
Split Income
Spousal Or Common-Law Partner Trust
Tax Planning
Testamentary Trust
Trust
Trustee
Twenty-One (21) Year Deemed Disposition Rule
Will

# References

19-181. For more detailed study of the material in this Chapter, we would refer you to the following:

| | |
|---|---|
| ITA 70(6) | Transfers To Spousal Trusts On Death |
| ITA 73(1) | Inter-Vivos Transfers To Spousal Trusts |
| ITA 74.1 to 74.5 | Attribution Rules |
| ITA 75(2) | Trust (Attribution To Settlor) |
| ITA 85(1) | Transfer Of Property To Corporation By Shareholders |
| ITA 86(1) | Exchange Of Shares By A Shareholder In Course Of Reorganization Of Capital |
| ITA 104 to 108 | Trusts And Their Beneficiaries |
| ITA 122 | Tax Payable By Inter Vivos Trust |
| ITA 122.1 | Definitions (SIFT Trusts) |
| ITA 197 | Tax On SIFT Partnership |
| IC-76-19R3 | Transfer Of Property To A Corporation Under Section 85 |
| S6-F1-C1 | Residence Of A Trust Or Estate |
| S6-F2-C1 | Disposition Of An Income Interest In A Trust |
| IT-209R | Inter-Vivos Gifts Of Capital Property To Individuals Directly Or Through Trusts |
| IT-286R2 | Trusts - Amount Payable |
| IT-291R3 | Transfer Of Property To A Corporation Under Subsection 85(1) |
| IT-305R4 | Testamentary Spouse Trusts |
| IT-342R | Trusts - Income Payable To Beneficiaries |
| IT-369R | Attribution Of Trust Income To Settlor |
| IT-381R3 | Trusts - Capital Gains And Losses And The Flow-Through Of Taxable Capital Gains To Beneficiaries |
| IT-394R2 | Preferred Beneficiary Election |
| IT-406R2 | Tax Payable By An Inter Vivos Trust |
| IT-465R | Non-Resident Beneficiaries Of Trusts |
| IT-510 | Transfers and Loans of Property Made After May 22, 1985 to a Related Minor |
| IT-511R | Interspousal And Certain Other Transfers And Loans Of Property |
| IT-524 | Trusts - Flow Through Of Taxable Dividends To A Beneficiary After 1987 |
| T4013 | Trust Guide |

# Problems For Self Study (Online)

To provide practice in problem solving, there are Self Study and Supplementary Self Study problems available on MyLab Accounting.

Within the text we have provided an indication of when it would be appropriate to work each Self Study problem. The detailed solutions for Self Study problems can be found in the print and online Study Guide.

We provide the Supplementary Self Study problems for those who would like additional practice in problem solving. The detailed solutions for the Supplementary Self Study problems are available online, not in the Study Guide.

The .PDF file "Self Study Problems for Volume 2" on MyLab contains the following for Chapter 19:

- 6 Self Study problems,
- 2 Supplementary Self Study problems, and
- detailed solutions for the Supplementary Self Study problems.

# Assignment Problems

(The solutions for these problems are only available in the solutions manual that has been provided to your instructor.)

### Assignment Problem Nineteen - 1

#### (Property Transfer To And From A Trust)

Each of the following independent Cases involve transfers of property to trusts by a settlor for no consideration. Three of the Cases also involve capital distributions from trusts to capital beneficiaries.

A. A gift of non-depreciable capital property is made to a qualifying spousal inter vivos trust. The adjusted cost base of the property to the settlor was $45,700. At the time of the transfer the fair market value of the property is $51,000. At a later point in time, the property is transferred to the spouse. At this time the fair market value of the property is $49,200.

B. A gift of depreciable capital property (a rare violin) is made to an inter vivos trust in favour of the settlor's adult children. The capital cost of the violin to the settlor, a world renowned violinist was $125,000. On the date of the gift, the UCC was $72,000 and the fair market value was $155,000.

C. A transfer of a piece of vacant land is made to a qualifying spousal testamentary trust. The cost of the land for the deceased spouse was $200,000, and the fair market value on the date of the transfer to the trust is $225,500. At the time of his death, the decedent had a large net capital loss carry forward of $78,000.

D. A depreciable property is transferred to an inter vivos trust in favour of the settlor's adult children. The capital cost of the property is $17,600 and its UCC is $9,100. It is the last asset in its class. At the time of the transfer, the fair market value of the property is $5,000.

E. A gift of non-depreciable capital property is made to an inter vivos trust in favour of the settlor's adult children. The adjusted cost base of the property to the settlor was $36,900. Its fair market value on the date of the gift is $40,200. At a later point in time, when the fair market value of the property is $51,700, the property is transferred to the children.

F. A non-depreciable capital property is transferred to an alter ego trust. The cost of the capital property to the settlor was $101,500. On the date of the transfer, the estimated fair market value is $92,300. At a later point in time, when the estimated fair market value of the property has increased to $100,000, the property is transferred back to the settlor.

**Required:** For each Case indicate:

1. The tax consequences to the settlor that result from the transfer of the property to the trust assuming the transfer price is chosen to optimize the tax position of the settlor.
2. The tax value(s) for the transferred property that will be recorded by the trust.
3. In those cases where property is transferred to a beneficiary, the tax consequences to the trust and the tax value(s) that will be recorded by the beneficiary.

### Assignment Problem Nineteen - 2

**(Inter Vivos Trusts - Income Attribution)**

In the process of planning an estate freeze, Glen Marx intends to transfer a large group of publicly traded common stocks to a trust. The terms of this trust will require that, on an annual basis, 50 percent of the income of the trust be distributed to his wife, Greta Petrov, with the remaining 50 percent split equally between their son, Sergey and daughter, Anastasia. Sergey is 23 years old and has employment income of over $35,000 per year. Anastasia is 19 years old and has employment income of over $25,000 per year.

The trust's income will consist of interest, dividends, and capital gains.

The terms of the trust require that all of the trust's assets be distributed 15 years subsequent to the date on which it was established. This distribution will use the same allocation that is used for annual distributions.

**Required:**

A. Identify the type of trust that is being used.

B. How should the trust's year end date be chosen?

C. Indicate the persons that will have to include the trust's income in their Net Income For Tax Purposes. Would your answer change if Anastasia was 17 years of age? If so, explain how.

D. Explain how your answer to Part C would change if Mr. Marx forms the trust by the settlement of a nominal amount of cash. Mr. Marx then lends money to the trust to purchase the portfolio investments from him at their fair market value. Assume:
   1. the loan is an interest free loan;
   2. the trust pays interest at the prescribed rate on the loan.

E. Would the taxation of the trust income change if Mr. Marx and Mrs. Petrov were living separately because of a marriage breakdown? Explain your conclusion.

### Assignment Problem Nineteen - 3

**(Trusts And Income Splitting)**

Hannah Brood is an engineer with 2019 employment income of $235,000. In addition, she has holdings of debt securities that produce a total of $65,000 in interest during 2019.

She has a 19 year old son from her first marriage. The son's name is Harvey Rosen and he is enrolled as a freshman at a Canadian university. It is Harvey's life-long dream to be an accounting professor. Given this, he anticipates that he will be enrolled in university programs for at least 8 more years. Hannah expects that the cost of his living expenses, tuition, and books will be about $55,000 per year during this period. Harvey's father disappeared without a trace when Harvey was born and has never paid any child support.

While she has had three other marriages, she eventually found married life very dreary and is now separated from her most recent husband. However, she still loves children. To satisfy this maternal need, she arranged to have another child with sperm donated by her gay brother-in-law. This child is now a 1 year old named Carl Brood. Currently, Carl is cared for by

a nanny who is paid $17,000 per year. When Carl reaches 4 years of age, Hannah intends to send him to a private school. She anticipates that the cost of the private school will be similar to the cost of the nanny.

Hannah does not anticipate that either child will have significant income until they complete university.

Hannah would like to transfer the debt securities to a trust for her children. As her employment income is more than sufficient for her needs, she hopes to use the trust to split income both currently and in future years. She has indicated that, while she wants to support her children fully, she does not want the trust to provide them with any direct payments until they are 30 years old. Until then, she wants the trust to pay for their care, education, and other direct expenses.

**Required:** Outline how a trust might be used to split income with Hannah's children. Ignore the possibility that some of the trust's distributions might be subject to the TOSI.

## *Assignment Problem Nineteen - 4*

### *(Graduated Rate Estates - Tax Minimization)*

After a long battle with cancer, Mr. Thomas Holt died on March 3, 2018. His will specifies that all of the considerable assets in his estate are to be transferred to a testamentary trust.

Because of difficulties with locating some of Mr. Holt's assets, the transfer to a trust has not been implemented prior to December 31, 2018. Given this, the executor of his estate files a T3 tax return for the period ending December 31, 2018. This return designates Mr. Holt's estate as a Graduated Rate Estate (GRE).

Due to administrative delays of various sorts, Mr. Holt's assets remain under the administration of the executor at December 31, 2019. Because of this, the executor files a T3 return for the GRE for the year ending December 31, 2019.

The beneficiaries of the trust are Mr. Holt's wife, Renfrew Holt. She is a very successful trial lawyer with an annual income in excess of $275,000. Their 22 year old daughter Roxanne has struggled, for several years, to have a career as a folk singer. She has not enjoyed much success and, as a consequence, she has no Taxable Income for 2019.

In his will, Mr. Holt included a provision which allowed income distributions to these beneficiaries during the period that his estate is being administered by an executor. While the provision allows for distributions to either beneficiary, the timing and amounts are at the discretion of the executor.

For the year ending on December 31, 2019, the GRE had the following income receipts:

| | |
|---|---|
| Interest | $43,000 |
| Eligible Dividends Received From Canadian Corporations | 31,200 |
| Total Income | $74,200 |

**Required:**

A. With a view to minimizing total Tax Payable for the GRE and the beneficiaries, determine the amounts and type of income that should be distributed to each beneficiary for 2019.

B. Using the allocations you determined in Part A, calculate the total federal Tax Payable for the GRE and Roxanne Holt for the year ending on December 31, 2019. In addition, indicate any additional taxes that would be paid by Renfrew Holt for 2019 as the result of the GRE distributions.

Ignore the possibility that some of the trust's distributions might be subject to the TOSI.

### Assignment Problem Nineteen - 5

#### (Inter Vivos Trusts - Tax Payable)

During 2017, Valerie Larson's parents both died when their private jet was hit by a drone while circling the Toronto Island airport. As an only child, Valerie inherited a substantial estate.

Her parents had transformed the family construction business from a one man operation (her father) into a very successful online market place for quality construction services. Valerie and her two sons, Louis and Gabriel had worked for the Canadian controlled private company, Larson Services Inc. (LS) all their working lives.

Valerie decided to transfer the investments she inherited into a trust with her two sons as beneficiaries. The fiscal year of the trust ends on December 31, and Ms. Larson has no beneficial interest in either the income or capital of the trust. As the president of LS, her compensation is more than adequate for her financial needs.

Louis is aged 30, while Gabriel is 25. The terms of the trust specify that Louis is to receive 10 percent of all of the income of the trust, while Gabriel is to receive 50 percent of this income. The reason for the difference in percentages is that Louis is addicted to opioids. After the death of his grandparents, he turned to street drugs to help cope with his grief. Louis is in a long term treatment program for his addiction and he is making impressive progress.

The undistributed income is to accumulate within the trust, to be paid out to Louis when his doctors tell Valerie his addiction is under control.

The income figures for the year ending on December 31, 2019, are as follows:

| | |
|---|---:|
| Non-Eligible Dividends Received From LS | $450,000 |
| Interest Income On Corporate Bonds | 37,000 |
| Revenues From Rental Property | 205,000 |
| Cash Expenses On Rental Property | 125,350 |

During 2019, the rental property was sold. The property consisted of an apartment building and the land on which it was located, all of which was transferred into the trust when Valerie inherited it. The relevant information related to the disposition is as follows:

| | Building | Land |
|---|---:|---:|
| Proceeds Of Disposition | $3,200,000 | $728,000 |
| Undepreciated Capital Cost | 1,881,600 | N/A |
| Capital Cost/Adjusted Cost Base | 2,000,000 | 500,000 |

This is the first disposition of capital property by the trust since its establishment.

**Required:**

A. Calculate the Taxable Income of the trust for the year ending December 31, 2019. In addition, calculate the increase in Taxable Income resulting from being beneficiaries of the trust for Louis and Gabriel for the same period.

B. Calculate the federal Tax Payable for the trust, for the year ending December 31, 2019.

### Assignment Problem Nineteen - 6

#### (Graduated Rate Estates - Transfers and Tax Payable)

Rhett Buttler died on March 22, 2018. The assets in his estate are to be transferred to a testamentary trust whose beneficiaries are his wife Scarlett and their adult, transgender son/daughter Ashley.

The executor of Rhett's estate missed a curve while driving his Maserati very fast. He survived the car crash with extensive physical damage, but with minor impairment to his mind. As a consequence of the accident he was not able to fully perform his executor duties for an extended period of time. As a result, on March 21, 2020, the assets of the estate are still under his administration.

The executor had filed a T3 return for the non-calendar fiscal year ending March 21, 2019, designating the estate as a Graduated Rate Estate (GRE).

For the fiscal year ended March 21, 2020, the GRE has the following:

| | |
|---|---|
| Business Income | $50,000 |
| Interest | 7,500 |
| Non-Eligible Dividends Received From CCPC | 125,000 |
| Rent Receipts | 30,000 |
| Rental Operating Expenses | 15,000 |
| CCA On Rental Property | 5,000 |

As he had anticipated difficulties in settling his estate, Rhett's will indicated that the executor should make distributions of his estate's income until such time as the assets are transferred to the testamentary trust. All distributions are to be made on the last day of the fiscal period of the GRE, i.e., on March 21, 2020 for the second fiscal year.

Assume his will contained the following instructions:

**Alternative One** One-half of any dividend income is to be retained in the GRE. The remaining one-half of the dividend income, as well as all of the other net income is to be paid 60 percent to Scarlett and 40 percent to Ashley.

**Alternative Two** All of the GRE's income will be allocated to Scarlett and Ashley on a 60 percent and 40 percent basis.

Scarlett and Ashley have no other sources of income. They have no personal tax credits under ITA 118 other than their basic personal credit and any credits that may arise from income allocations from the GRE.

**Required:**

A. For each of the alternatives, calculate Taxable Income and federal Tax Payable for the fiscal year ending March 21, 2020 for the GRE.

B. For each of the alternatives, calculate Taxable Income and federal Tax Payable for Scarlett and Ashley for the year ending December 31, 2020.

C. Compare the amount of federal Tax Payable under each of the two alternatives and explain the difference.

Assume that the tax rates and tax brackets for 2020 are the same as those for 2019. Also, assume that none of the trust's distributions will be subject to the TOSI.

### Assignment Problem Nineteen - 7

**(Graduated Rate Estates - Transfers and Tax Payable)**

Martha Dagger was killed in a paragliding accident on March 15, 2019. Her will requires that all of the property in her estate be transferred to a testamentary trust. The beneficiaries of the trust will be her 22 year old daughter, Sharon Dagger and her 14 year old son, Morris Dagger. Because of complications related to transferring the assets to the trust, on December 31, 2019, the estate assets are still under the administration of her executor.

The executor files a T3 tax return for the fiscal period ending on December 31, 2019 designating Martha's estate as a Graduated Rate Estate (GRE). While the executor could have chosen a non-calendar taxation year, he decided to use December 31 as the year end for the GRE.

Information on the property owned by Martha at her death is as follows:

| | Tax Cost | Fair Market Value March 15, 2019 |
|---|---|---|
| Shares In Deadly Dagger Inc. (a CCPC) | $ 897,000 | $1,472,000 |
| Corporate Debt Securities | 478,000 | 456,000 |
| Rental Property | | |
| Land | 562,000 | 864,000 |
| Building (Cost = $1,740,000) | 1,390,374 | 2,476,000 |

Deadly Dagger Inc. is a qualified small business corporation. Martha has available a lifetime capital gains deduction of $250,000 [(1/2)($500,000)] and no CNIL.

Martha's will specifies that 70 percent of any income that accrues in her estate prior to the estate assets being transferred to the testamentary trust be distributed on the basis of 40 percent to Sharon and 30 percent to Morris. The remaining 30 percent will be allowed to accumulate in the GRE.

Between March 15, 2019 and December 31, 2019, the following income and expense amounts were recorded by the GRE:

| | | |
|---|---|---|
| Non-Eligible Dividends Received | | $124,000 |
| Interest On Corporate Debt Securities | | 31,650 |
| Net Rental Income: | | |
| Rental Revenues | $251,600 | |
| Rental Expenses Other Than CCA | ( 172,940) | |
| CCA Claimed | ( 55,615) | 23,045 |
| Total Income | | $178,695 |

**Required:**

A. Determine the increase in Martha's 2019 Taxable Income that will result from her death.

B. For the fiscal period ending on December 31, 2019, determine the Taxable Income for the GRE and the total Taxable Income allocated to each beneficiary.

C. Calculate the federal Tax Payable for the GRE for the fiscal period ending on December 31, 2019.

### Assignment Problem Nineteen - 8

#### (Estate Freeze)

Mr. and Mrs. Zahar own a very lucrative company, Zeus Goose Ltd. The fair market value of the common shares is $5,000,000 and they have a nominal cost base and paid up capital.

The Zahar's want to set up an estate freeze to pass on future growth of the Company to their three children, all of whom are in their twenties. Mr. and Mrs. Zahar are in their early fifties and want to continue to control the Company for many years. While they have obtained information on how a corporate reorganization can be used to effect an estate freeze, they would also like to investigate the use of trusts in their estate planning.

**Required:** Outline important issues that should be considered by Mr. and Mrs. Zahar if they are to use trusts in an estate freeze.

Ignore the possibility that some of the trust's distributions might be subject to the TOSI.

### Assignment Problem Nineteen - 9

#### (Estate Planning)

One of your clients, Daniel Loh has read several articles describing the tax advantages of charitable donations. Mr. Loh is 73 years old and has had a very successful career in business in Canada. As a consequence, he owns a wide variety of investments in publicly traded securities and private company shares, as well as real estate in Canada and Singapore. You estimate that his assets have a current value in excess of $15 million.

Due to a car accident in Singapore that disfigured him horribly and made him a recluse, he has never married and has no friends or living relatives. When he dies, he intends to leave all of his assets to a group of his favourite charities.

As he has never spent any time on estate planning, he has asked you to help him understand the issues and give him suggestions of what he should consider.

**Required:** Write a brief report providing the advice requested by your client.

# CHAPTER 20

# International Issues In Taxation

## Introduction

### Subjects Covered

20-1. This Chapter 20 is something of a potpourri of issues that are loosely related by their association with transactions and events that extend beyond Canada's borders. In some cases, we are dealing with the application of Canadian tax law to transactions and events that occur outside of Canada. In other cases, we are concerned only with the fact that individual taxable entities are moving between Canada and other jurisdictions. Some of these transactions and events relate to taxation that is associated with the laws that exist in jurisdictions outside of Canada.

20-2. In dealing with the diverse nature of the material covered, we have organized this Chapter as follows:

**Residence** While some of the material related to residence involve international issues, these issues were covered in our comprehensive coverage of residence in Chapter 1.

**Taxation Of Canadian Source Income Earned By Non-Residents** While the basic approach to the assessment of income tax in Canada is to assess tax on Canadian residents, under certain circumstances, non-residents can be required to pay Canadian income taxes. Depending on the type of income, the tax may be assessed under Part I, Part XIII, or other Parts of the *Income Tax Act*. Detailed consideration will be given to Part I and Part XIII tax as they are the most commonly applied provisions.

**Immigration And Emigration** We touched on this subject in Chapter 8 when we covered the deemed disposition of most capital assets when an individual emigrates from Canada. In this Chapter, we will consider some of the other complications associated with leaving Canada, as well as tax considerations related to immigration.

**Taxation Of Foreign Source Income Earned By Residents** This material begins by discussing the reporting requirements applicable to Canadian residents who have foreign investments. This is followed by material dealing with resident taxpayers who have the following types of income:

- foreign source employment income;
- foreign source income from unincorporated businesses;
- foreign source interest income; and
- capital gains resulting from the disposition of foreign assets.

The remainder of the chapter provides limited coverage of dividend income received by Canadian residents from non-resident entities. This would include material on foreign affiliates, controlled foreign affiliates, and foreign accrual property income (FAPI). Some of this material is extremely difficult to understand and because of this, some instructors may choose not to include it in their courses.

## The Role of International Tax Treaties

20-3. Tax treaties are entered into between countries for the purpose of facilitating cross-border trade and investment by removing income tax obstacles. For example, a Canadian resident employed in the U.S. is potentially subject to Canadian tax under the residence approach. In the absence of a treaty, he could also be subject to U.S. tax on the same income under the source approach. This would, of course, create a significant impediment to cross-border employment.

20-4. In addition to dealing with double taxation problems such as this, treaties also provide income tax certainty, prevent discrimination, ensure a proper division of cross-border revenues, and provide an information-sharing mechanism for the purposes of administration and enforcement of each country's tax laws.

20-5. In cases where there are conflicts, Canada's tax treaties generally override the *Income Tax Act*. This override occurs through legislation that implements the tax treaty, as well as specific provisions of the *Income Tax Act* that recognize the priority given to the tax treaty. For example, ITA 2(3) requires a U.S. resident to pay Canadian tax on employment income earned in Canada. The tax treaty, on the other hand, may, in specific circumstances, state that such income is only taxable in the U.S. In such cases, the inconsistency is resolved through the application of the tax treaty with the result that no Canadian tax is payable by the U.S. resident.

# Part I Tax On Non-Residents

## Introduction

### *Applicability*

20-6. As covered in Chapter 1 in our material on residence, ITA 2(1) states that Canadian taxes are payable by residents of Canada on their world wide taxable income for a taxation year. While this statement makes it clear that Canadian residents are responsible for paying Canadian income taxes, it does not address the question of whether non-residents are responsible for such taxes.

20-7. Also as mentioned in Chapter 1, ITA 2(3) specifies that non-residents are responsible for Canadian Part I tax (tax assessed on Taxable Income) on certain types of income. As listed in that subsection, non-residents are responsible for:

- income earned while carrying on a business in Canada;
- employment income earned in Canada; and
- gains and losses resulting from dispositions of Taxable Canadian Property.

20-8. In this Chapter we will give attention to the assessment of Canadian Part I tax on non-residents in situations where they have any of these three types of income. As part of this discussion, we will provide coverage of the provisions of the U.S./Canada tax treaty that relate to such situations. Coverage of other international tax treaties goes beyond the scope of this text.

20-9. You will note that ITA 2(3) covers business income, employment income, and capital gains on Taxable Canadian Property, but this subsection does not refer to property income.

Further there is no reference to pension income, management fees, or capital gains on Canadian property other than those items that are classified as Taxable Canadian Property. This means that, in general, non-residents are not responsible for paying Part I tax on these types of Canadian source income.

20-10. However, this is not the end of the story. When these other types of income are from a Canadian source and are earned by non-residents, a separate Part XIII tax is applicable. The application of this tax will be covered beginning in Paragraph 20-31.

### Filing Requirements

20-11. In those situations where a non-resident has Tax Payable under Part I, a Canadian income tax return is required (see T4058, *Non-Residents And Income Tax*). The normal filing dates for individuals and corporations are applicable in such situations. No Canadian income tax return is required if there is no Part I Tax Payable.

### Taxable Income

20-12. As some of the items that must be included in a Canadian income tax return by non-residents are exempted by various international tax treaties, such amounts can be deducted in determining Taxable Income. In addition, under ITA 115(1), non-residents will also be able to deduct Canadian employment losses, Canadian business losses, various types of loss carry overs, Canadian stock option benefits, Canadian dividends received (corporations only), and charitable donations (corporations only).

20-13. If 90 percent or more (substantially all) of the taxpayer's worldwide income is included in their Part I tax return, the other Taxable Income deductions that are available to residents, such as the lifetime capital gains deduction, become available to non-residents.

### Tax Payable

20-14. Unless the non-resident's Part I return includes 90 percent or more of their worldwide income, ITA 118.94 prohibits the use of the majority of non-refundable tax credits. However, the following credits will be available to non-resident filers who are individuals if they have any amount of Canadian source income included in their Part I return.

- EI and CPP tax credits
- charitable donations tax credit
- disability tax credit (for taxpayer only)
- tuition tax credit
- interest on Canadian student loans tax credit

## Carrying on Business in Canada

### General Rules

20-15. As we have noted, non-residents are subject to Part I tax in Canada on income from businesses carried on in Canada. The rules for calculating business income discussed in Chapter 6 are generally applicable to non-residents. However, for non-residents, ITA 253 expands the concept of a business by deeming non-residents to be carrying on a business with respect to certain activities such as:

- Producing, growing, mining, creating, manufacturing, fabricating, improving, packing, preserving, or constructing, in whole or in part, anything in Canada.
- Soliciting orders or offering anything for sale in Canada through an agent or servant, whether the contract or transaction is to be completed inside or outside Canada.
- Disposing of certain property, such as real property inventory situated in Canada, including an interest in, or option on, such real property.

20-16. These rules are intended to ensure that certain Canadian activities that are connected to the non-resident's foreign business, are potentially taxable in Canada as business income. Without these rules, it could be questionable whether the non-resident person

would be considered to be carrying on a business in Canada.

**EXAMPLE** A U.S. business sends sales representatives to Canada to solicit orders. If the sales contracts can only be finalized in the U.S., under the general rules applicable to business income, it could be argued that no business was carried on in Canada. However, ITA 253 makes it clear that the soliciting of orders in Canada is carrying on business in Canada, without regard to where the contracts are finalized.

### Canada/U.S. Tax Treaty On Business Income

20-17. The treaty allows Canada to tax the business income of U.S. residents, provided that business is operated in Canada through what is referred to as a permanent establishment.

20-18. Article V of the Canada/U.S. tax treaty defines a "permanent establishment" as a fixed place of business through which the business of a non-resident is wholly or partly carried on. The treaty provides additional clarification by adding that fixed places of business include a place of management, a branch, an office, a factory, a workshop, a mine, an oil or gas well, a quarry or other place of extraction of natural resources. Additional rules provide permanent establishment status only if certain conditions are met (e.g., most construction projects are only considered permanent establishments if they last for more than twelve months).

20-19. The treaty specifically excludes facilities from being considered a fixed place of business if they are used exclusively for certain activities. These activities include:

- use of facilities solely for storage, display, or delivery of goods;
- maintenance of a stock of goods or merchandise for storage, display, or delivery;
- maintenance of a fixed place of business solely for purchasing goods or merchandise, or for collecting information; or
- maintenance of a fixed place of business solely for the purpose of carrying on any other activity of a preparatory or auxiliary character.

20-20. The tax treaty also deems certain persons to be permanent establishments of a non-resident. Two examples of this are as follows:

- An agent who acts on behalf of a non-resident enterprise and who is authorized to conclude contracts in the name of that enterprise, is considered a permanent establishment.
- An individual who acts on behalf of a business and meets both a physical presence test (183 days or more in any 12 month period beginning or ending in the year) and a gross revenue test (that more than 50% of the gross active business revenues of the U.S. business are from services performed by that individual during the period the individual is in Canada), is considered a permanent establishment.

## Exercise Twenty - 1

**Subject:** Carrying On Business In Canada

In each of the following Cases, determine whether Jazzco, a U.S. corporation, is taxable in Canada:

**Case 1** Jazzco, a U.S. corporation, is the parent company of Bluesco, a company incorporated in Ontario. Jazzco produces and sells Jazz CDs, while Bluesco produces and sells Blues CDs. Jazzco sells CDs to Bluesco, who in turn sells them in Canada.

**Case 2** Jazzco sets up a factory in Toronto where they produce CDs for the Canadian market. The CDs are sold exclusively to an independent Canadian franchise retail outlet at a 50 percent mark-up.

**Case 3** Jazzco manufactures Jazz CDs in the U.S. Jazzco ships CDs to a warehouse located in Calgary that they have rented on a five year lease. Jazzco has employed an individual in Calgary to sell the CDs throughout western Canada. The employee,

however, is not allowed to conclude contracts without approval by the U.S. office.

**Case 4** Assume the same facts as in Case 3, except that the employee has the authority to conclude contracts on behalf of the employer.

**Case 5** Assume the same facts as in Case 3, except that the employee has an office in the warehouse premises where he solicits orders.

**SOLUTION available in print and online Study Guide.**

## Canadian Source Employment Income

### *General Rules*

20-21. As noted, under ITA 2(3), non-resident individuals are subject to Part I tax on Canadian source employment income. For this purpose, net employment income is calculated using the same rules that are applicable to residents earning Canadian source employment income. These rules were covered in Chapter 3.

20-22. In addition to this provision, ITA 115(2) deems certain non-resident individuals to be employed in Canada, even when the work is not carried on in this country. Such individuals include:

- Individuals who have become residents of another country and continue to receive employment remuneration from a resident Canadian source, provided a tax treaty exempts that remuneration from taxation in the foreign country.
- Non-resident individuals who have received signing bonuses and other similar amounts that relate to services to be performed in Canada, in situations where the resident Canadian employer is entitled to deduct the amounts in computing Canadian Income.

20-23. The basic idea behind these provisions is that, if payments are made to a non-resident that are deductible to a Canadian resident, the payments will be taxed in Canada if they are not taxed in the other country. Note, however, that employee remuneration is generally exempted from Canadian taxation if it is subject to tax by the foreign country.

### *Canada/U.S. Tax Treaty On Employment Income*

20-24. In general, a source country has the right to tax the employment income of non-residents when it is earned within its borders. This view is reflected in ITA 2(3) which assesses Part I tax on Canadian source employment income earned by non-residents. However, the Canada/U.S. tax treaty contains two special rules which create exceptions to this general approach.

**$10,000 Rule** Under this rule if, during a calendar year, a U.S. resident earns employment income in Canada that is $10,000 or less in Canadian dollars, then the income is taxable only in the U.S.

**183 Day Rule** This rule exempts Canadian source employment income from Canadian taxation, provided it is earned by a U.S. resident who was physically present in Canada for no more than 183 days during any twelve month period commencing or ending in the calendar year. This exemption is conditional on employment income not being paid by an employer with a permanent establishment in Canada who would be able to deduct the amount paid from their Canadian Income. Stated alternatively, if the employment income exceeds $10,000 and is deductible in Canada, it will be taxed in Canada, even if the employee is present in Canada for less than 183 days during the year.

20-25. It is important not to confuse the 183 day period in the treaty with the 183 day sojourner rule for determining residence. (See Chapter 1.) While the treaty rule applies to any physical presence in Canada, the sojourner rule applies to temporary visits or stays. Daily commutes to Canada from the U.S. for employment purposes would count towards the 183 days in the treaty rule, but not towards the 183 days in the sojourner rule.

## Exercise Twenty - 2

**Subject:** Non-Resident Employment In Canada

Dawn Johnson is employed by Alberta Oil Ltd. as an oil well technician in Edmonton. She has accepted a transfer to the Egyptian offices of the Company for three years beginning January 1, 2019. Dawn severs her residential ties to Canada on December 31, 2018 and takes up residence in Egypt. Alberta Oil continues to pay her salary. Although the government of Egypt would normally tax such salary, the tax treaty between Canada and Egypt exempts the salary from tax in Egypt. Is Dawn required to pay Canadian tax on the salary paid to her by Alberta Oil? Justify your conclusion.

## Exercise Twenty - 3

**Subject:** Non-Resident Employment In Canada - Canada/U.S. Tax Treaty

In each of the following Cases, determine whether the employment income is taxable in Canada:

**Case 1** David resides in the state of Washington. He accepted temporary employment as a technician with a Canadian company to do service calls in the Vancouver area for four months beginning September 1, 2019. The Canadian employer agreed to pay him $2,800 Canadian per month. David remained a non-resident of Canada throughout his Canadian employment.

**Case 2** Assume the same facts as in Case 1, except the employer was resident in Washington and did not have a permanent establishment in Canada.

**Case 3** Sandra resides in Detroit, Michigan and has commuted daily to a full-time job in Windsor, Ontario for the last three years. In 2019, she spent 238 days at her job in Canada. She works for the municipality of Windsor and earned $50,000 Canadian in employment income. Sandra is a U.S. resident throughout the year.

**SOLUTIONS available in print and online Study Guide.**

## Dispositions of Taxable Canadian Property

### *General Rules*

20-26. As we have previously noted, under ITA 2(3), non-residents are taxable on gains resulting from dispositions of Taxable Canadian Property. The general rules for dealing with capital gains and losses were covered in detail in Chapter 8. While we only considered their application to Canadian residents in that Chapter, these rules are equally applicable to non-residents.

20-27. As defined in ITA 248(1), the main categories of Taxable Canadian Property are as follows:

- Real property situated in Canada.
- Certain capital property or inventories of a business carried on in Canada.
- A share of an unlisted corporation, an interest in a partnership, or an interest in a trust if, at any time within the preceding 60 months, more than 50 percent of the fair market value of the share or interest was derived from certain properties including Canadian real property, Canadian resource properties and timber resource properties.
- A share of a listed corporation only if, at any time within the preceding 60 months, at least 25 percent of the issued shares of any class were owned by the non-resident taxpayer and/or non-arm's length persons, and more than 50 percent of the shares' fair market value was derived from certain properties including Canadian real property, Canadian resource properties and timber resource properties.

### Compliance Certificates

20-28. There are, of course, problems related to having a non-resident comply with Canadian tax rules related to dispositions of Taxable Canadian Property. To deal with this, ITA 116 requires a non-resident, who anticipates a disposal of Taxable Canadian Property, to file Form T2062, "Request by a Non-Resident of Canada for a Certificate of Compliance Related to the Disposition of Taxable Canadian Property". This form, which must be filed within 10 days of the planned disposition, must be accompanied by a payment of 25 percent of the anticipated capital gain on the disposition (some types of security are acceptable). When these conditions are met, a certificate of compliance will be issued. There is a penalty for disposing of a Taxable Canadian Property without obtaining a compliance certificate.

20-29. As Canadian tax authorities are still dealing with a non-resident, this procedure does not ensure compliance. What serves to ensure that Canadian taxes will be paid is a requirement that, if the non-resident seller does not acquire a compliance certificate, the purchaser (usually a Canadian resident) is responsible for the 25 percent payment on behalf of the non-resident. Note, however, that ITA 116(5) provides an exception to this if, after reasonable enquiry the purchaser had no reason to believe that the seller was not resident in Canada.

### Canada/U.S. Tax Treaty On Taxable Canadian Property Dispositions

20-30. While the general rule in ITA 2(3) indicates that non-residents are taxable on gains resulting from dispositions of Taxable Canadian Property, it is necessary to examine the Canada/U.S. tax treaty to see if any of its provisions override this general rule. The treaty acts to limit Canadian taxation on U.S. residents to gains arising from only the following specific types of Taxable Canadian Property:

- real property situated in Canada;
- property forming part of a permanent establishment of the non-resident in Canada; and
- investments such as shares of corporations resident in Canada and interests in partnerships and trusts where the value of those investments is primarily attributable to real property situated in Canada.

## Exercise Twenty - 4

**Subject:** Dispositions Of Taxable Canadian Property

In each of the following Cases the individual is a U.S. resident who is disposing of a property. Determine whether any gain on the disposition is taxable under Part I in Canada.

**Case 1** In 2019, Nancy Gordon disposed of shares of a widely held Canadian public company that she acquired in 2016. Nancy never owned more than one-quarter of one percent of the outstanding shares of this company. The company's assets consist entirely of real estate situated in Canada.

**Case 2** In 2014, Joe Nesbitt acquired a condo in Whistler that he rented to Canadian residents. He sold the condo in 2019 at a considerable gain. Joe never occupied the condo.

**Case 3** Assume the same facts as in Case 2, except that Joe incorporates a private corporation under British Columbia legislation solely to acquire the condo. At a later point in time, Joe sells the shares at a considerable gain.

**Case 4** Assume the same facts as in Case 3, except the corporation is created under Washington state legislation.

**SOLUTION available in print and online Study Guide.**

**We suggest you work Self Study Problem Twenty-1 at this point.**

# Part XIII Tax On Non-Residents

## Introduction

### Applicability

20-31. In the preceding section of this Chapter, we dealt with the application of Part I tax to certain specific types of income earned by non-residents. As noted in Paragraph 20-10, this leaves many other types of Canadian source income that are not subject to Part I tax in the hands of non-residents.

20-32. The Part XIII tax is designed to correct this situation. ITA 212 provides a long list of income types to which this tax is applicable. While most of the items on the list fall into the property income category, there are other items such as pension benefits. Notably absent, however, are taxable capital gains on assets other than Taxable Canadian Property. Capital gains on dispositions of other Canadian assets are not taxed in the hands of non-residents, either under Part I or Part XIII.

20-33. Three other points are relevant here:

- Part XIII tax is an alternative to Part I tax. There are no situations in which both taxes would be applied to a single income source.
- Non-residents are not required to file a Canadian tax return for income that is subject to Part XIII tax.
- In general, it is the resident payer who is responsible for withholding the Part XIII tax from payment(s) being made to the non-resident, as well as remitting the withheld amounts to the CRA. The payer is also responsible for filing an information return (NR4) indicating the amounts withheld.

20-34. As indicated, Part XIII tax applies to a long list of income types. However, in the following material, we will limit our coverage to interest, royalties, rents, dividends, and pension benefits earned or accruing to non-residents.

### The Nature Of Part XIII Tax

20-35. This is a very different type of tax than that which is assessed under Part I. Under Part I, the relevant tax rate is applied to Taxable Income, a figure that is made up of components which are calculated on a net basis. For example, interest revenues are only included after any related expenses are deducted. In contrast, the Part XIII tax is assessed on the gross amount of income received.

> **EXAMPLE** Ms. Johnson borrows $100,000 to invest in high yield bonds. During the current year, they produce interest income of $9,000, while the interest costs for the borrowing amount to $4,000.
>
> **ANALYSIS** If Ms. Johnson was a Canadian resident being taxed under Part I of the *Income Tax Act*, the applicable tax rate would be applied to $5,000 ($9,000 - $4,000). In contrast, if Ms. Johnson was a non-resident being taxed under Part XIII, the Part XIII withholding rate would be applied to the $9,000 in interest received.

### Rates

20-36. The Part XIII rate that is specified in ITA 212(1) is 25 percent for all types of income listed in ITA 212. However, this rate is rarely applied when the recipient of the income is resident in a country with which Canada has a tax treaty. All of these treaties have provisions which, while allowing the applicability of the Part XIII tax, modify the rate. This is further complicated by the fact that the rate modifications vary between the various types of income subject to the Part XIII tax.

20-37. Comprehensive treatment of the various rates that are applicable under Canada's many international tax treaties would not be appropriate in a general text such as this. However, because it would appear to be the most important of these treaties, attention will be given to the rates that are applicable under the Canada/U.S. tax treaty.

## Interest Payments

### *Part XIII Rules*

20-38. ITA 212(1)(b) assesses Part XIII tax on only two types of interest. These are as follows:

> **Participating Debt Interest** Participating debt interest is defined in ITA 212(3) as interest that is dependent on the use of property (e.g., royalties), or that is calculated by reference to revenue, cash flow, or profit. What is being described here is amounts that, while they may be called interest, are more like business income. They are not based on a principal sum and the passage of time.
>
> **Interest Paid To Non-Arm's Length Non-Residents**, unless the interest is **Fully Exempt Interest**. Fully exempt interest is defined in ITA 212(3) as interest paid or payable on certain types of government issued or guaranteed debt (e.g., debt issued by the government of Canada or a province).

20-39. Another way of stating this would be to note that Part XIII tax only applies to:

- arm's length arrangements when the interest payments are related to "participating debt", and
- non-arm's length arrangements if the interest is not fully exempt.

### *Canada/U.S. Tax Treaty On Interest Payments*

20-40. When it is established that Part XIII tax is applicable, it is then necessary to consult the relevant international tax treaty to determine whether Canada has the right to tax such amounts. For U.S. residents, the Canada/U.S. tax treaty states the following:

> **Article XI** Interest arising in a Contracting State and beneficially owned by a resident of the other Contracting State may be taxed only in that other State.

20-41. This means that, with respect to interest paid to U.S. residents, Canada does not have the right to withhold taxes under Part XIII. Residents of the U.S. are exempt from the Part XIII tax, even in the situations described in Paragraph 20-38.

## Exercise Twenty - 5

**Subject:** Interest Payments To Non-Residents

In each of the following Cases, determine whether the interest payments made to non-residents are subject to Part XIII withholding tax, and if so, at what rate.

**Case 1** Jason, a resident of a country that does not have a tax treaty with Canada, earned $3,000 in interest from a term deposit in a Canadian bank during 2019.

**Case 2** Janice, a resident of a country that does not have a tax treaty with Canada, earned interest of $1,800 on Government Of Canada bonds during 2019.

**Case 3** Julian, a resident of Ottawa, acquired a vacation property in a country that does not have a tax treaty with Canada. The property is mortgaged with a bank in the foreign country. Julian paid $12,000 in interest to the foreign bank in 2019.

**Case 4** Jasmine, a resident of Manitoba, paid $5,000 in interest on a loan from her brother, a resident of Ohio during 2019.

**SOLUTION available in print and online Study Guide.**

## Dividend Payments

### Part XIII Rules

20-42. Most types of dividends are subject to the 25 percent Part XIII tax. This includes capital dividends, despite the fact that they are not subject to tax when received by Canadian residents.

### Canada/U.S. Tax Treaty On Dividend Payments

20-43. While there is nothing in the Canada/U.S. tax treaty to prevent the application of this tax to U.S. residents, the treaty serves to reduce the applicable rate. In this case, there are two different reduced rates, depending on the percentage of the dividend paying corporation that is owned by the non-resident recipient.

> **5 Percent Rate** If the U.S. resident recipient is a corporation and owns 10 percent or more of the voting shares of the resident Canadian company that is paying the dividend, the applicable rate is only 5 percent. This 5 percent rate for inter-corporate dividends reflects a view that dividend payments between parent companies and their subsidiaries should be less heavily taxed to encourage international trade and investment.
>
> **15 Percent Rate** Other dividends paid by resident Canadian companies to shareholders who are U.S. residents are subject to the Part XIII withholding tax at a reduced rate of 15 percent.

## Royalty Payments

### Part XIII Rules

20-44. Royalties paid or credited to non-residents by a person resident in Canada are generally subject to a 25 percent Part XIII withholding tax under ITA 212(1)(d). Specifically excluded under Canadian legislation are payments for copyright use, payments made under cost-sharing arrangements where the costs are shared with non-residents, and arm's length payments made that are deductible under Part I against business income earned outside Canada.

### Canada/U.S. Tax Treaty On Royalty Payments

20-45. The Canada/U.S. tax treaty, in general, allows the imposition of Part XIII tax on royalties. However, it is at a reduced rate of 10 percent. The treaty further provides that copyright and computer software royalties are not taxable by the source country.

## Rental Income

### Part XIII Rules

20-46. The situation with rent payments is more complex. While ITA 212(1)(d) lists rents as one of the items subject to Part XIII tax, the *Income Tax Act* is designed to give priority to Part I tax over Part XIII tax. However, as we have noted in our discussion of the small business deduction, a taxpayer's rental activities may be so extensive that they can be considered a business. If this is the case, the non-resident taxpayer will be earning business income which will be subject to Part I tax in Canada. If this is the case, the taxpayer will have to file an income tax return including these amounts. However, there will then be no requirement to pay Part XIII tax on the rental revenues.

### An Important Election For Rental Income Of Non-Residents

20-47. If the non-resident is not carrying on a rental business in Canada, Part XIII tax is applicable. This creates a significant problem in that the Part XIII tax is applied to gross rental revenues, a figure that will usually be much larger than net rental income.

**EXAMPLE** Marcia Dorne, a resident of a non-treaty country, owns a rental property in Canada. The gross rent on this property is $120,000 for the year and is paid monthly at a rate of $10,000. The property is so heavily financed that net rental income, as determined by the Part I rules, is $12,000 for the year before CCA of $11,000.

**ANALYSIS** In the absence of an alternative approach, Marcia would be subject to Part XIII tax of $30,000 [(25%)($120,000)].

20-48. Fortunately, there is an alternative approach. Under ITA 216, Marcia can elect to pay taxes under Part I, rather than under Part XIII. In the preceding example, this election would result in Part I taxes being paid on the net rental income of $1,000 ($12,000 - $11,000 CCA). If Marcia had no other source of Canadian income, this $1,000 would be taxed at the lowest federal rate of 15 percent and, when combined with the 48 percent federal surtax on income not earned in a province, the total Part I tax would be $222 [(15%)($1,000)(148%)]. This is well below the $30,000 that would be assessed under Part XIII.

20-49. With respect to this election, two other points are worth noting:

- In general, this election can only be made in situations where the rental property is real property located in Canada.
- If a non-resident taxpayer makes this election, they will file a separate return including only the revenues and expenses related to their rental property. They cannot make any deductions from Net Income in the determination of Taxable Income and they cannot deduct any of the ITA 118 personal tax credits.

### Solution To The Cash Flow Problem

20-50. Unfortunately, use of the ITA 216 election to pay under Part I tax does not relieve the payer from the requirement to withhold Part XIII tax. This will, in many cases, create a significant tax flow problem for the non-resident landlord. Consider the example from Paragraph 20-47. The person paying the rent would have to withhold a total of $30,000 from the payments made to Marcia Dorne. As a result, she would have a negative cash flow of $18,000 [($120,000 - $30,000) - ($120,000 - $12,000)]. While the withheld Part XIII tax would eventually be refunded, there is a significant outflow of cash during the rental period.

20-51. Fortunately, there is a solution to this problem. A non-resident taxpayer can file Form NR6, "Undertaking to File an Income Tax Return by a Non-Resident Receiving Rent from Real Property or Receiving a Timber Royalty". If this undertaking is filed, the payer can base the required withholding on 25 percent of the estimated net rental income before the deduction of CCA. In our Paragraph 20-47 example, the Part XIII withholding would be reduced from $2,500 per month [(25%)($10,000)] to $250 per month [(25%)(1/12)($12,000)]. Any difference between this amount and the actual net rental income, including any available deduction for CCA, would be claimed when Marcia Dorne's Part I tax return is filed.

### Canada/U.S. Tax Treaty On Rental Income

20-52. The Canada/U.S. tax treaty allows the imposition of Part XIII tax to rental income. When the rental property is real property, the statutory Part XIII rate of 25 percent is applicable. However, where the rental property is something other than real property in Canada (e.g. equipment or machinery), the Canada/U.S. tax treaty reduces the Part XIII withholding rate from 25 to 10 percent.

## Exercise Twenty - 6

**Subject:** Rental Payments To Non-Residents

In each of the following Cases, determine how the rental payments made to non-residents will be taxed by Canada. In addition, indicate whether an election to pay Part I tax is available and whether the election would be desirable.

**Case 1** Rentco is a U.S. corporation with worldwide rental facilities dedicated to various equipment rentals. Rentco has offices in Saskatchewan, where it rents out farming equipment.

**Case 2** In 2016, Jack Foster, a U.S. resident, acquired a hunting and fishing lodge in northern Ontario that he rents out. In 2019, he rented the lodge to Canadian residents exclusively. Jack received $42,000 in gross rents and estimates that expenses, including CCA, totaled $14,000.

**Case 3** Assume the same facts as in Case 2, with one additional consideration. Jack acquired three motor boats in 2017, which he rented to guests of the lodge. In 2019, he received $8,000 in gross boat rents and estimates boat related expenses of $7,000.

**SOLUTION available in print and online Study Guide.**

## Pension Payments And Other Retirement Related Benefits

### *Part XIII Rules*

20-53. Amounts received by non-residents as pension or other retirement related benefits are generally subject to tax under Part XIII. This would include OAS payments, CPP payments, death benefits, certain retiring allowances, as well as payments from RRSPs, RRIFs, and DPSPs. Payments from TFSAs are not considered pension payments, but there are special rules for individuals who own TFSAs and become non-resident.

20-54. There are some exceptions under Canadian legislation that are designed to ensure that a non-resident will only be taxed on amounts that would have been taxable had the non-resident been resident in Canada at the time the benefits were earned. For example, a non-resident may receive a pension from a former Canadian employer, most of which relates to years in which the person was non-resident and worked outside Canada. Part XIII may exempt the part of the pension that relates to employment outside Canada.

### *An Important Election For Pension Income Of Non-Residents*

20-55. The non-resident recipient of Canadian pension income can elect under ITA 217 to be taxed under Part I of the *Income Tax Act*, rather than under Part XIII. Unlike the ITA 216 election for rental income, this alternative requires the reporting of all Canadian sourced income, not just Canadian pension income, but it allows non-residents to claim deductions and credits normally given to Canadian residents. More detailed information is available on the CRA website in T4145, "Electing Under Section 217 of the *Income Tax Act*".

20-56. For a low income individual, choosing to use the ITA 217 election can provide a significant advantage in that it will allow the individual to make use of some of the tax credits that are available under Part I. However, for high income individuals, the Part XIII rate is likely to be lower than the rate that would be applicable under Part I of the *Act*. In most cases, this will more than offset the loss of tax credits.

### Canada/U.S. Tax Treaty On Pension Payments And Benefits

20-57. The Canada/U.S. tax treaty permits the application of Part XIII tax to pension or other retirement related benefits paid to U.S. residents. As usual, the treaty acts to reduce the applicable Part XIII rate, in this case to 15 percent. However, this rate is only available on benefits that are periodic payments. If the benefit is a lump-sum payment (e.g., a retiring allowance), the statutory Part XIII rate of 25 percent must be used.

20-58. Payments from OAS, CPP and QPP are generally subject to Part XIII tax and eligible for the optional Part I treatment discussed in Paragraph 20-55. However, with respect to OAS and CPP payments made to a resident of the U.S., the treaty specifies that these will only be taxed in the U.S. There will be no withholding or filing requirements on these amounts.

20-59. Two other important provisions under the U.S./Canada treaty can be described as follows:

> **Contributions To Local Plans By Non-Residents** The treaty allows deductions for contributions by non-residents to "qualifying retirement plans" that are located in the other country. This means that U.S. residents who contribute to a qualifying Canadian plan can deduct their contributions from Canadian income and, alternatively, Canadian residents who contribute to a U.S. plan can deduct their contributions from U.S. income. Two points are relevant here:
>
> - For U.S. residents working in Canada, qualifying retirement plans include RPPs, DPSPs, and group RRSPs. Individual RRSPs do not qualify.
> - Deductions for contributions to Canadian plans are limited by the available RRSP contribution room.
>
> **Contributions and Accruing Benefits By Residents** The second provision relates to ongoing contributions and benefits accruing under a pension plan in the country in which the individual is resident. Contributions to such plans are deductible in the other country, but benefits accruing would not be taxable. For example, if a U.S. resident employed in Canada continued to make contributions to a U.S. plan, the U.S. contributions would be deductible against Canadian employment income. However, any pension benefits that accrued would not be taxable in Canada.

## Shareholder Loans To Non-Residents

20-60. In Chapter 15, we gave attention to the rules associated with shareholder loans. It was noted that, in general, the principal of such loans had to be included in a taxpayer's Net Income For Tax Purposes. There are a number of exceptions to this rule. However, in situations where the principal is not included, there is still a taxable benefit to the shareholder if the interest rate on the loan was less than the prescribed rate.

20-61. As non-residents are generally not required to file a Part I tax return, corporate loans to non-resident shareholders would be exempt from these rules in terms of the application of Part I tax. However, ITA 214(3)(a) indicates that if ITA 15 of the *Income Tax Act* (Benefit Conferred On Shareholder) would require an amount to be included in income, that amount will be viewed as a dividend paid to the non-resident shareholder, resulting in the application of Part XIII tax. A refund of the Part XIII tax will become available when the loan is repaid.

20-62. Such loans to non-resident shareholders escape this treatment if they are repaid within one year of the end of the taxation year in which the loan is provided. If the principal is not included in income and the interest rate on the loan is less than the prescribed rate, a benefit will be calculated in the same manner as the interest benefit on such loans when they are made to a resident shareholder. However, when a non-resident is involved, this benefit will be treated as a dividend subject to Part XIII tax.

**We suggest you work Self Study Problem Twenty-2 at this point.**

# Immigration And Emigration

## Entering Canada - Immigration

### *Deemed Disposition/Reacquisition*

20-63. The rules related to entering Canada are found in ITA 128.1(1). Paragraph (b) of this subsection indicates that, with certain exceptions, a taxpayer is deemed to have disposed of all of their property immediately before entering Canada for proceeds equal to fair market value. Paragraph (c) calls for a deemed reacquisition of the property at the same fair market value figure.

20-64. This process establishes a new cost basis for the taxpayer's property, as at the time of entering Canada. The goal here is to avoid having Canadian taxation apply to gains that accrued prior to the individual's immigration.

> **EXAMPLE** An individual enters Canada with securities that cost $100,000 and have a current fair market value of $150,000.
>
> **ANALYSIS** In the absence of the ITA 128.1(1)(b) and (c) deeming provisions, a subsequent sale of these securities for $150,000 would result in the $50,000 accrued gain being taxed in Canada, despite the fact that it accrued prior to the individual becoming a Canadian resident.

20-65. The properties that are excluded from the deemed disposition/reacquisition are listed in ITA 128.1(1)(b). In general, these are items that would already have been subject to tax in Canada if the taxpayer was a non-resident. They include:

- Taxable Canadian Property.
- Inventories and certain other capital assets of a business carried on in Canada.
- **"Excluded Right or Interest"** This concept is defined in ITA 128.1(10). The definition includes RPP balances, RRSP balances, DPSP balances, stock options, death benefits, retiring allowances, as well as other rights of individuals in trusts or other similar arrangements.

## Departures From Canada - Emigration

### *Deemed Disposition On Leaving Canada*

20-66. As was noted in Chapter 8, when a taxpayer leaves Canada, ITA 128.1(4)(b) calls for a deemed disposition of all property owned at the time of departure. The disposition is deemed to occur at fair market value (see Paragraph 20-69 for treatment under the Canada/U.S. tax treaty). If the taxpayer is an individual, certain types of property are exempted from this deemed disposition rule. The major categories of exempted property are:

- Real property situated in Canada, Canadian resource properties, and timber resource properties.
- Property of a business carried on in Canada through a permanent establishment. This would include capital property and inventories.
- Excluded rights or interests of the taxpayer as described in Paragraph 20-65.

**Exercise Twenty - 7**

**Subject:** Emigration

Ms. Gloria Martell owns publicly traded securities with an adjusted cost base of $28,000 and a fair market value of $49,000. During the current year, she permanently departs from Canada still owning the shares. What would be the tax consequences of her departure, if any, with respect to these securities?

**SOLUTION available in print and online Study Guide.**

## Exercise Twenty - 8

**Subject:** Emigration

Mr. Harrison Chrysler owns a rental property in Nanaimo, B.C. with a capital cost of $190,000 and a fair market value of $295,000. The land values included in these figures are $45,000 and $62,000, respectively. The UCC of the building is $82,600. During the current year, Mr. Chrysler permanently departs from Canada. What are the current and possible future tax consequences of his departure with respect to this rental property?

**SOLUTION available in print and online Study Guide.**

### Problems With The Current System

20-67. Taxpayer emigration is a problem area for those in charge of Canadian tax policy. To begin, Canada is significantly out of line with all of its trading partners in the manner in which it deals with the accrued capital gains of emigrants.

20-68. As an illustration of this problem, consider Mr. Poutine, who departs from Canada at a time when he owns capital assets with an adjusted cost base of $80,000 and a fair market value of $120,000. On his departure from Canada, Mr. Poutine will be deemed to have disposed of these assets at their fair market value of $120,000, resulting in an assessment for a capital gain of $40,000. In many other countries, this would not occur. Mr. Poutine would be able to remove his assets without taxation and retain an unchanged adjusted cost base.

20-69. The deemed disposition can result in double taxation as Mr. Poutine's new country of residence may consider his adjusted cost base to be the original value of $80,000. Fortunately, the Canada/U.S. tax treaty provides a fix for this situation. Under Article XIII(7), Mr. Poutine can elect to have a deemed disposition at fair market value for U.S. tax purposes as well as for Canadian tax assessment, but this fix is not available for all countries.

20-70. A further problem in this area is the ability of some taxpayers to avoid the Canadian emigration tax rules, resulting in large sums of money being removed from Canada on a tax free basis. Some types of assets can be removed tax free on the assumption that they will be subject to Canadian taxation at a later point in time. This might not happen if one of Canada's bilateral tax treaties prohibits Canadian taxation after an individual has been a non-resident for a specified period of time.

20-71. Other leakages can occur when assets are bumped up in value for foreign tax purposes, with no corresponding change in the Canadian tax base. This is essentially what happened in the Bronfman trust case, in which several billion dollars in assets were removed from Canada without being subject to Canadian income taxes on accrued gains.

### Elective Dispositions

20-72. As noted in the preceding Paragraphs, certain types of property are exempted from the deemed disposition rules. There may, however, be circumstances in which an individual wishes to override these exemptions and trigger capital gains at the time of departure. An important example of this would be farm property that qualifies for the lifetime capital gains deduction. (See Chapter 11 for details of this deduction.)

20-73. An individual may wish to trigger income or losses on the exempted property at the time of departure for other reasons. An example of this would be an emigrant who wants to realize a loss on exempt property in order to offset a gain on non-exempt property.

20-74. Such situations are provided for in ITA 128.1(4)(d), which allows an individual to elect to have a deemed disposition on certain types of properties that are exempt from the general deemed disposition rule. The properties on which the election can be made include real property situated in Canada, Canadian resource and timber resource properties, as well as property of a business carried on in Canada through a permanent establishment. Note that, if this election results in losses (capital or terminal), they can only be used to offset income resulting from other deemed dispositions. They cannot be applied against other sources of income, including capital gains from actual dispositions, for the taxation year.

## Exercise Twenty - 9

**Subject:** Emigration

Ms. Gloria Lopez owns shares in a Canadian private company with an adjusted cost base of $120,000 and a fair market value of $235,000. In addition, she owns a rental property with a fair market value of $130,000 ($30,000 of this can be attributed to the land) and a cost of $220,000 ($60,000 of this can be attributed to the land). The UCC of the building is $142,000. During the current year, Ms. Lopez permanently departs from Canada. Calculate the minimum Net Income For Tax Purposes that will result from her departure with respect to the shares and the rental property.

**SOLUTION available in print and online Study Guide.**

### *Security For Departure Tax*

20-75. The preceding deemed disposition rules can be very burdensome for an emigrating individual. If the individual has substantial amounts of property on which gains have accrued, the deemed disposition rules can result in a hefty tax bill. This is further complicated by the fact that there are no proceeds of disposition to provide funds for paying this liability.

20-76. In recognition of this problem, ITA 220(4.5) through (4.54) allow the taxpayer to provide security in lieu of paying the tax that results from the deemed dispositions. Similar provisions have been added such as ITA 220(4.6) through (4.63) for dealing with trusts distributing Taxable Canadian Property to non-residents.

20-77. ITA 220(4.5) requires the CRA to accept "adequate security". Guidance on what constitutes adequate security is as follows:

> Bank letters of guarantee, bank letters of credit, and bonds from the Government of Canada or a province or territory of Canada are considered acceptable forms of security. Other types of security may also be acceptable, such as shares in private or publicly traded corporations, certificates in precious metals, various other marketable securities, a charge or mortgage on real property, or valuable personal property.

20-78. If the taxpayer elects under ITA 220(4.5), interest does not accrue on the tax that has been deferred until the amount becomes unsecured. This will usually be at the time when there is an actual disposition of the property that was subject to the deemed disposition.

20-79. A final point here is that ITA 220(4.51) creates deemed security on an amount that is the total amount of taxes under Part I that would be payable, at the highest tax rate that applies to individuals, on Taxable Income of $50,000. This amount is one-half of a $100,000 capital gain, and the effect of this provision is to exempt emigrants from the requirement to provide security on the first $100,000 in capital gains resulting from their departure.

**We suggest you work Self Study Problem Twenty-3 at this point.**

## Unwinding A Deemed Disposition

### The Problem

20-80. A potential problem can arise when an individual departs from Canada and, at a later point in time, returns. A simple example will serve to illustrate this difficulty:

> **EXAMPLE** John Fuller emigrates from Canada on June 1, 2019. At that time, he owns shares of a private company with a fair market value of $200,000 and an adjusted cost base of $125,000. As a result of the deemed disposition/reacquisition of these shares, he has a taxable capital gain of $37,500 [(1/2)($200,000 - $125,000)]. In 2020, he returns to Canada. At the time of immigration, he still owns the shares and their fair market value has increased to $260,000.

20-81. In the absence of any special provision (and ignoring the deemed security rules discussed in Paragraph 20-75), Mr. Fuller's departure from Canada would cost him the taxes paid on the $37,500 taxable capital gain arising on the deemed disposition at emigration. On his return, the adjusted cost base of his property would be increased to $260,000 (deemed disposition/re-acquisition on immigration). However, the fact remains that his temporary absence has resulted in an out-of-pocket tax cost on the $37,500 taxable capital gain.

### The Solution

20-82. ITA 128.1(6) provides relief in this type of situation. With respect to Taxable Canadian Property such as Mr. Fuller's, ITA 128.1(6)(a) allows a returning individual to make an election with respect to property that was Taxable Canadian Property at the time of emigration. The effect of making this election is that the deemed disposition that was required under ITA 128.1(1)(b) at the time of departure, is reversed when the individual returns to Canada. As there is no real basis for establishing whether an emigrant will eventually return as an immigrant, ITA 128.1(6) has no influence on the tax consequences arising at the time of emigration.

20-83. Returning to our example from Paragraph 20-80, if this election is made, the addition to Taxable Income that was assessed when Mr. Fuller left Canada would be reversed through an amended return, resulting in a refund of the taxes paid.

20-84. As the deemed disposition at departure has been reversed, there would be no need for a disposition/reacquisition when he returns to Canada. This means that after the appropriate election and amended return are filed, Mr. Fuller would wind up in the same tax position as he was in before he departed from Canada. That is, he would own securities with an adjusted cost base of $125,000 with no net taxes paid as a result of his departure and return.

## Short-Term Residents

20-85. With the increasing presence of multi-national firms in the Canadian business environment, it has become common for executives and other employees to find themselves resident in Canada for only a small portion of their total working lives. In the absence of some special provision, the deemed disposition rules could be a significant hardship to employees who are in this position.

20-86. For example, if Ms. Eng was transferred from Hong Kong to work in Canada for three years, she could become liable on departure for capital gains taxation on all of her capital property owned at the time that she ceases to be a resident of Canada. The liability could put a severe drain on her available liquid assets and could result in taxation on personal items such as paintings and furniture (note that, in many cases, where the individual is in the country for a limited period and working for a non-resident employer, the individual would be taxed as a resident of the foreign country, and not as a resident of Canada). This would not be an equitable situation and could discourage the free movement of employees to and from Canada.

20-87. In recognition of the preceding problem, ITA 128.1(4)(b)(iv) provides an exception to the deemed disposition rules that applies to taxpayers who, during the ten years preceding departure, have been resident in Canada for a total of 60 months or less. For such taxpayers,

the deemed disposition rules do not apply to any property that was owned immediately before the taxpayer last became resident in Canada, or was acquired by inheritance or bequest during the period after he last became resident in Canada. However, the rules still apply to property acquired other than by inheritance or bequest during the period of residency.

### Exercise Twenty - 10

**Subject:** Short Term Residents

During 2016, Charles Brookings moves to Canada from the U.K. He has not previously lived in Canada. At this time his capital assets consist of shares in a U.K. company and a tract of vacant land in Canada which he had inherited. The shares have a fair market value of $250,000 and an adjusted cost base of $175,000. The land had a fair market value of $95,000 when he inherited it and a fair market value of $120,000 when he moves to Canada in 2016.

During 2017, he acquires shares of a Canadian public company for $75,000. During 2019, after finding Canada a tad uncivilized for his tastes, he moves back to the U.K. At this time, the shares in the U.K. company have a fair market value of $280,000, the shares of the Canadian company have a fair market value of $92,000 and the land has a fair market value of $130,000.

What are the tax consequences of his emigration from Canada?

**SOLUTION available in print and online Study Guide.**

# Foreign Source Income Of Canadian Residents

## Introduction

20-88. It would be a fairly easy task to write an entire book on the tax issues associated with the foreign source income of Canadian residents. One version of the draft legislation on non-resident trusts and foreign investment entities ran to nearly 900 pages in its print edition. In addition to being extensive, much of this material is extremely complex, in some cases almost beyond the understanding of mere mortals. Despite this complexity, the importance of this subject mandates that we give some attention to the issues, even in an introductory text such as this. Although some aspects of foreign source income of Canadian residents are relatively straightforward, you should be aware that this material is not an adequate resource for making important decisions in this potentially complicated area.

20-89. We will begin this section on foreign source income of residents by discussing the reporting requirements applicable to Canadian residents who have foreign investments. This will be followed by sections dealing with resident taxpayers having the following:

- foreign source employment income;
- foreign source income from unincorporated businesses;
- foreign source interest income; and
- capital gains resulting from the disposition of foreign assets.

20-90. The issues involved for taxpayers having these types of income sources are not overly complex. However, a completely different situation arises when Canadian resident taxpayers receive income from what tax legislation refers to as non-resident entities. These entities are defined as corporations, trusts, or any other type of entity that was formed, organized, last continued under, or governed under the laws of a country, or a political subdivision of a country, other than Canada. In order to simplify our presentation of this material, we will limit our coverage of this material to non-resident corporations paying dividends to Canadian resident taxpayers.

## Foreign Investment Reporting Requirements

20-91. As you are aware, residents of Canada are liable for income taxes on their worldwide income. This means, for example, that if a Canadian resident has a bank account in England, any interest earned on that account should be reported in the taxpayer's Canadian tax return.

20-92. There is little doubt that evasion of taxes on foreign income has been fairly common in the past. In an attempt to curtail tax evasion on foreign property and to amass information on foreign property owned by Canadians, the CRA requires the following:

> All Canadian resident taxpayers are required to file form T1135, *Foreign Income Verification Statement* if, at any time in the year the total cost amount (not fair market value) of all specified foreign property to the taxpayer was more than $100,000 in Canadian dollars.

20-93. The T1135 offers a simplified reporting method to taxpayers whose specified foreign property totals more than $100,000, but less than $250,000 throughout the year. Rather than having to report the complete details on the T1135, the simplified method allows a taxpayer to report a single figure for the total income from all specified foreign property, as well as for the gain (loss) from the disposition of all specified foreign property for the year. For example, the taxpayer will be able to report a single figure for the total value of non-resident securities held, rather than having to report each individual security in this category.

20-94. The T1135 form requires information on what is referred to as "specified foreign property". The more important types of specified foreign property are as follows:

- funds held outside Canada (e.g., funds in a foreign bank account);
- shares of a non-resident corporation (See Paragraph 20-97 for a streamlined option to these reporting requirements for foreign shares held in Canadian brokerage accounts);
- indebtedness owed by a non-resident;
- real property outside of Canada other than excluded property such as personal use or business use properties (See Paragraph 20-95); and
- an interest in a non-resident trust.

20-95. Some of the common items excluded from the definition of specified foreign property are as follows:

- foreign securities held in Canadian mutual funds, or inside a registered account like an RRSP, RRIF, TFSA or RESP;
- a property used or held exclusively in carrying on an active business;
- a personal use property, such as a second home; and
- a share of the capital stock or indebtedness of a foreign affiliate.

20-96. For taxpayers with less than $250,000 in specified foreign property, completing the simplified form (Part A of the T1135) is not particularly onerous. For taxpayers with specified foreign property equal to $250,000 or more, a great deal of additional information is required such as:

- the name of the entity holding or issuing the property, or a description of the foreign property;
- the relevant country code (for the country of residence of the bank, corporation, issuer or trust, or where the property is located);
- the maximum cost amount of the property during the year;
- the year end cost amount of the property;
- the amount of income or loss related to the property for the year; and
- any capital gain or loss realized on the disposition of the property during the year.

20-97. Fortunately, in many, if not most cases, relief is available. To the extent specified foreign property is held in an account with a Canadian registered securities dealer or a Canadian trust company, the only requirements related to specified foreign property are reporting country-by-country aggregate values for maximum fair market value during the year, fair

market value at the end of the year, income for the year, and gains or losses on dispositions during the year. For example, if an individual invests only in U.S. stocks and they are held with a Canadian registered securities dealer, the reporting requirements are greatly simplified. This is likely the situation for many of the individuals who are required to report their specified foreign property.

20-98. Substantial penalties can result from failure to comply with these reporting requirements. They range from $500 per month for up to 24 months if the failure to file is done knowingly to $1,000 per month for up to 24 months if there is a failure to comply with a demand to file the T1135. After 24 months, the penalty can become more severe, i.e., 5 percent of the cost of the foreign property.

### Exercise Twenty - 11

**Subject:** Foreign Investment Reporting

During 2019, Simon Taylor, a Canadian resident, has a bank account at the Bank of Scotland. The balance ranged from £4,000 to £52,000 during the year and has a balance of £41,000 on December 31, 2019. Interest on the account for the year totalled £1,000. In 2018, he made a 2 year interest free loan of £145,000 to his brother-in-law who is a resident of Scotland. No formal loan agreement was involved. Assume 1£ = $1.70 for 2018 and 2019. Describe the foreign investment reporting obligations that Simon has for 2019 and provide the information required.

**SOLUTION available in print and online Study Guide.**

**We suggest you work Self Study Problem Twenty-4 at this point.**

## Foreign Source Employment Income

### *The Problem*

20-99. Individuals who are residents of Canada are taxable on employment income regardless of where the employment duties are performed. This creates a potential problem in that an individual earning employment income in a foreign country could be subject to Canadian taxes because they have retained their status as a Canadian resident and, at the same time, be subject to taxes in the foreign country because it is the source of the employment income. Tax treaties would normally be used to resolve this potential conflict.

### *Canada/U.S. Tax Treaty - Foreign Source Employment Income*

20-100. This problem is, of course, the mirror image of the problem that arises when a U.S. resident is earning employment income while working in Canada. In our discussion of that situation (see Paragraph 20-21), we noted that, in general, the source country has the right to tax employment income. We also noted that, under the Canada/U.S. tax treaty, there were two exceptions to this rule. As applied to a situation where a Canadian resident is earning U.S. employment income, these exceptions are as follows:

**$10,000 Rule** Under this rule if, during a calendar year, a Canadian resident earns employment income in the U.S. that is $10,000 or less in U.S. dollars, then the income is taxable only in Canada.

**183 Day Rule** This rule exempts U.S. source employment income from U.S. taxation, provided it is earned by a Canadian resident who was physically present in the U.S. for no more than 183 days during any twelve month period commencing or ending in the calendar year. This exemption is conditional on employment income not being paid by an employer with a permanent establishment in the U.S. who would be able to deduct the amount paid from their U.S. Taxable Income. Stated

alternatively, if the employment income exceeds $10,000 and is deductible in the U.S., it will be taxed in the U.S., even if the employee is present in the U.S. for less than 183 days during the year.

**We suggest you work Self Study Problem Twenty-5 at this point.**

## Foreign Source Business Income (Unincorporated Sources)

### *The Problem*

20-101. The general rule that Canadian residents are taxable on their worldwide income would suggest that Canadian residents are taxable on foreign source business income. As was the case with foreign source employment income, this creates a potential problem in that a person earning business income in a foreign country could be subject to Canadian taxes because they have retained their status as a Canadian resident and, at the same time, be subject to taxes in the foreign country because it is the source of the business income.

20-102. In many cases, the potential for double taxation is dealt with through international tax treaties. If this is not the case, a Canadian resident may have some amount of taxes withheld in the foreign jurisdiction. In these circumstances, Canada uses foreign tax credits to deal with the problem. While these credits were covered in detail in Chapter 11 for individuals and Chapter 12 for corporations, a simple example where the detailed calculations would have resulted in a foreign tax credit equal to the foreign tax withheld will serve to review the general approach used:

**EXAMPLE** Ms. Johnson, a Canadian resident, is subject to a Canadian marginal tax rate of 45 percent on all of her worldwide income. During the current year, she earns foreign source business income of $1,000, from which the source country assesses and withholds taxes at a rate of 15 percent.

**ANALYSIS** The pretax amount of foreign income would be included in Taxable Income, with the foreign taxes paid by Ms. Johnson, a Canadian resident, generating a credit against Canadian Tax Payable. Applying this to the preceding example results in the following calculations:

| | |
|---|---|
| Foreign Business Income Received | $ 850 |
| Foreign Tax Withheld | 150 |
| Gross Income = Taxable Income Addition | $1,000 |
| Canadian Tax Payable [(45%)($1,000)] | $ 450 |
| Foreign Tax Credit = Foreign Tax Withheld | ( 150) |
| Net Canadian Tax Payable | $ 300 |
| Foreign Tax Withheld | 150 |
| Total Taxes Payable | $ 450 |
| After Tax Retention ($1,000 - $450) | $ 550 |
| Overall Tax Rate ($450 ÷ $1,000) | 45% |

As this simple example makes clear, this represents a very equitable solution to situations where foreign taxes are withheld on income that will be taxed again in Canada. The combined foreign and Canadian taxes total $450, exactly the same amount that would have been paid if Ms. Johnson had received the $1,000 in business income from a Canadian source.

### Canada/U.S. Tax Treaty - Foreign Source Business Income

20-103. As was discussed when we considered the Canadian business income of non-residents, the Canada/U.S. tax treaty indicates that business income will be taxed in the source country in those situations where the business is operated through a permanent establishment. Applying this here would mean that if a Canadian resident earns business income in the U.S. without having a permanent establishment in that country, it will be taxed in Canada, rather than in the U.S. Alternatively, if the business income is earned through a permanent establishment in the U.S., it will be taxed in that country. Any taxes withheld by the U.S. would be eligible for treatment as a foreign business tax credit. (See Chapters 11 and 12 for detailed coverage of this credit.)

#### Exercise Twenty - 12

**Subject:** Foreign Tax Credits

Jason Abernathy is a Canadian resident. During 2019, he earns $18,000 of business income through a permanent establishment located in the U.S. Income taxes of $1,800 were assessed and withheld at the source on that income. In calculating his foreign tax credit, his Adjusted Division B Income is equal to $100,000 and his Tax Otherwise Payable is equal to $21,000. All amounts are in Canadian dollars. Jason's marginal combined federal/provincial tax rate is 44 percent. Determine his after tax retention and overall tax rate on his foreign source business income.

**SOLUTION available in print and online Study Guide.**

## Foreign Source Interest Income

### The Problem

20-104. Resident Canadian taxpayers are taxable on interest income, generally without regard to the source. As was the case with employment income, this raises the possibility of double taxation. In most cases this issue will be resolved by an international tax treaty. If the issue is not resolved by treaty, the Canadian resident would have tax deductions and/or credits based on any foreign taxes withheld.

### Canada/U.S. Tax Treaty - Foreign Source Interest Income

20-105. As noted in Paragraph 20-40, Article XI of the Canada/U.S. tax treaty indicates that interest paid to the other jurisdiction will be taxed only in that jurisdiction. This means that U.S. residents receiving interest from a Canadian source are not subject to the Canadian Part XIII tax. Correspondingly, Canadian residents receiving interest income from a U.S. source will be subject to Part I taxes only in Canada.

## Foreign Source Capital Gains

### The Problem

20-106. The rules of the *Income Tax Act* relating to the calculation of capital gains and losses are generally applicable to residents of Canada on dispositions of property regardless of the location of that property. As was the case with foreign source employment and business income, dispositions of foreign property may result in potential taxation in both Canada and the foreign country. Again, the tax treaties would normally offer a way to resolve any conflicts.

### Canada/U.S. Tax Treaty - Foreign Source Capital Gains

20-107. In general, the Canada/U.S. tax treaty gives priority to tax to the vendor's country of residence. However, the treaty allows the U.S. to tax gains from the disposition of real property interests situated in the U.S., as well as gains on most types of property that are used in a permanent establishment through which a Canadian resident carries on business in the U.S.

## Foreign Source Dividend Income - Problems

20-108. Most foreign source investment income is taxed under the rules that are applicable to similar sources of income earned in Canada. An exception to this is dividends received from non-resident corporations.

20-109. As you are aware, dividends paid to Canadian residents by taxable Canadian corporations receive very favourable tax treatment. When such dividends are received by individuals, they are subject to the gross up and tax credit procedures, a process that significantly reduces the effective tax rate on this type of income. When the recipient shareholder is a corporation, the dividends generally escape all taxation in that they can be deducted under ITA 112(1) in the calculation of Taxable Income. Both of these provisions are designed to make up for the fact that the dividends represent an income stream that has already been subject to Canadian tax at the corporate level.

20-110. The basic problem with dividends received from a non-resident corporation is that the corporation that paid the dividends has not paid taxes in Canada. In fact, in some jurisdictions (e.g., tax havens), the corporation may not have paid any taxes whatsoever. This means that the usual reason for providing favourable treatment of dividend income is not relevant when dividends are received from a non-resident corporation.

20-111. A further problem is that the foreign source dividends do not reflect the type of income that provided for the payment of dividends by the foreign corporation. Again, as you are aware, Canadian taxes are generally assessed differently on alternative types of income. For example, a CCPC will be taxed much more heavily on property income as compared to the taxes that would be paid on active business income. To maintain fairness in the system, provisions had to be created that reflect the different sources of income that enabled the non-resident corporation to pay dividends.

20-112. In general, foreign source dividends must be included in a resident taxpayer's Net Income For Tax Purposes under ITA 90(1). When foreign source dividends are received by individuals, they do not get the benefit of the gross up and tax credit procedures. When they are received by corporations, they are not generally deductible under ITA 112(1).

20-113. While the elimination of favourable tax treatment for dividends from a foreign source provides a partial solution to the problem of dividends being paid out of corporate income that has not been taxed in Canada, two significant problems remain:

1. This procedure can result in double taxation. For example, income earned by a foreign subsidiary of a Canadian corporation could be fully taxed in the foreign jurisdiction and, in the absence of the ITA 112(1) dividend deduction, it would be taxed again in Canada.
2. Under the general rules applicable to corporations, income from a non-resident corporation will not be taxed in Canada until such time as it is distributed to Canadian residents. This means that a Canadian resident can achieve significant tax deferral by placing investments in a foreign corporation, in situations where the income from the investments is not currently needed. This is particularly attractive when the non-resident corporation is located in a jurisdiction where there is little or no taxation of investment income.

20-114. The first of these problems has been dealt with by developing the concept of a "foreign affiliate". As will be discussed in a subsequent section of this Chapter, dividends received from this type of non-resident corporation may be deductible, in whole or in part, to a recipient Canadian corporation. A partial solution to the second problem is contained in what are referred to as the Foreign Accrual Property Income (FAPI) rules. These rules apply to a subset of foreign affiliates referred to as controlled foreign affiliates.

20-115. In the following material, we will give consideration to dividends from foreign corporations that are received by:

- individuals resident in Canada;
- Canadian corporations that are not affiliated with the foreign corporation;
- Canadian corporations that are affiliated with the foreign corporation but do not control it; and
- Canadian corporations that control the foreign corporation.

20-116. We would remind you that our presentation of this material is at a very basic level and should be considered only as an overview of the topic and not as a guide for making real world decisions in this complex area.

## Foreign Source Dividends Received By Individuals

20-117. If a resident Canadian individual receives a dividend from a foreign corporation and there is no withholding of tax by the foreign jurisdiction, the amount received will be converted into Canadian dollars at the time that it is received. It would then be included in that individual's Net Income For Tax Purposes. It will not be grossed up and it will not generate a dividend tax credit.

20-118. Alternatively, if there is withholding by the foreign jurisdiction, the pre-withholding amount of the dividend will be included in the individual's Net Income For Tax Purposes. To the extent that the withholding is 15 percent or less, the individual is entitled to a foreign tax credit. Any withholding in excess of 15 percent is eligible for a deduction from Net Income For Tax Purposes.

20-119. While it would rarely be an appropriate choice, the individual would have the alternative of deducting the entire amount withheld, rather than using the eligible portion as a tax credit.

**EXAMPLE** During 2019, Martin Fingle is entitled to $25,000 in dividends from a foreign corporation in which he owns shares. The foreign jurisdiction withholds $5,000 (20%), providing a net receipt of $20,000. In addition to the dividend, Martin has Canadian source interest income of $22,000. Other than the foreign tax credit, he has other credits that total $2,200. He has no deductions from Net Income For Tax Purposes in determining Taxable Income.

**ANALYSIS** Martin's Taxable Income would be calculated as follows:

| | |
|---|---|
| Interest Income | $22,000 |
| Foreign Dividends (100%) | 25,000 |
| Excess Withholding [(20% - 15%)($25,000)] | ( 1,250) |
| Net Income For Tax Purposes And Taxable Income | $45,750 |

His Tax Payable would be calculated as follows:

| | |
|---|---|
| Tax Before Credits [(15%)($45,750)] | $ 6,863 |
| Personal Tax Credits | ( 2,200) |
| Part I Tax Payable Before Foreign Tax Credit | $ 4,663 |
| Foreign Tax Credit (See Note) | ( 2,548) |
| Federal Tax Payable | $ 2,115 |

**Note** The foreign tax credit would be the lesser of:

- Amount Withheld (Limited To 15% Of $25,000) = $3,750
- $\left[\frac{\text{Foreign Non - Business Income}}{\text{Division B Income}}\right](\text{Tax Payable}) = \left[\frac{\$25,000}{\$45,750}\right](\$4,663) = \$2,548$

20-120. While Martin could have deducted all of the withheld amount, his additional tax savings from this deduction would only be $382 [(15%)($2,548)]. This is clearly not as desirable as the $2,548 foreign tax credit alternative.

**We suggest you work Self Study Problem Twenty-6 at this point.**

## Foreign Dividends Received From Non-Affiliated Corporations

20-121. The pre-withholding amount of a dividend received by a Canadian corporation from a foreign corporation is always included in the corporation's Net Income For Tax Purposes. As a foreign affiliate is not involved, there would be no deduction in the determination of the corporation's Taxable Income.

> **EXAMPLE** Martin Fingle Inc., a Canadian public corporation, is entitled to $25,000 in dividends from a foreign corporation in which it owns less than 1 percent of the shares. The foreign jurisdiction withholds $5,000 (20%), providing a net receipt of $20,000. The corporate tax rate on this income, after the general rate reduction, will be 25 percent (38% - 13%). Assume that Martin Fingle Inc. has no other source of income during the year.
>
> **ANALYSIS** The Corporation's Taxable Income will be $25,000, the pre-withholding amount of the dividend. Tax Payable, before the application of the foreign tax credit will be $6,250 [(25%)($25,000)]. As a corporation's use of foreign non-business tax credits is not limited to 15 percent, the tax credit will be $5,000, the lesser of:
>
> - Amount Withheld (no 15% limit) = $5,000
> - $\left[\frac{\text{Foreign Non-Business Income}}{\text{Division B Income}}\right](\text{Tax Payable}) = \left[\frac{\$25{,}000}{\$25{,}000}\right](\$6{,}250) = \$6{,}250$

## Dividends Received From Non-Controlled Foreign Affiliates

### *Foreign Affiliate Defined*

20-122. A foreign affiliate of a Canadian taxpayer is defined in ITA 95(1) as a non-resident corporation in which that taxpayer has a direct or indirect equity percentage of at least 1 percent. As well, the aggregate equity percentages of the taxpayer and each person related to the taxpayer must be at least 10 percent. The ownership percentage can be established on either a direct or indirect basis, and is defined as the greatest percentage holding in any class of the non-resident corporation's capital stock.

20-123. As an example of both the direct and indirect application of this rule, consider the following example:

> **EXAMPLE** Candoo, a resident Canadian corporation, owns 70 percent of the only class of shares of Forco One, a non-resident corporation. In turn, Forco One owns 20 percent of the only class of shares of Forco Two, a second non-resident corporation.
>
> **ANALYSIS** Forco One is a foreign affiliate of Candoo because of Candoo's 70 percent direct ownership. Forco Two is also a foreign affiliate of Candoo because the indirect ownership percentage is 14 percent [(70%)(20%)].

20-124. We would also note that the ownership thresholds are applied on a shareholder by shareholder basis. A non-resident company will be a foreign affiliate of a Canadian resident, only if that resident owns directly or indirectly at least 1 percent of the shares of that non-resident company and, in addition, that resident, together with related persons, owns at least 10 percent of the shares of that non-resident company.

**EXAMPLE** Carson Ltd. and Dawson Inc., two resident Canadian companies, each own 8 percent of Belgique, a non-resident corporation. While Carson Ltd. is part of a related group that controls Belgique, Dawson Inc. is not related to any of the other shareholders of Belgique.

**ANALYSIS** Belgique would be a foreign affiliate of Carson Ltd. as Carson Ltd. owns more than 1 percent of the shares and, in addition, is part of a related group that owns more than 10 percent of the shares. Belgique would not be a foreign affiliate of Dawson Inc.

20-125. A foreign affiliate may or may not be a controlled foreign affiliate. In this section we are limiting our discussion to situations where control is not present. In the next section of this chapter, we will provide limited coverage of controlled foreign affiliates. Note that the rules discussed in this section apply to all foreign affiliates, whether or not control exists.

## Exercise Twenty - 13

**Subject** Identifying Foreign Affiliates

Canvest is a resident Canadian corporation that has three investments in the shares of non-resident corporations. For each of the investments in non-resident corporations described below, determine whether the investee is a foreign affiliate.

**Forco 1** Canvest owns 3 percent of Forco 1. A wholly-owned Canadian subsidiary of Canvest owns 8 percent of Forco 1.

**Forco 2** Canvest owns 9 percent of Forco 2. Canvest is not related to any of the other shareholders of Forco 2.

**Forco 3** Canvest owns 5 percent of Forco 3. The spouse of the shareholder who has a controlling interest in Canvest owns the other 95 percent of the shares of Forco 3.

**SOLUTION available in print and online Study Guide.**

### Dividends Received From Foreign Affiliates - Basic Concepts

20-126. We have previously noted that, in general, only dividends received from a taxable Canadian corporation can be deducted under ITA 112(1) in the determination of the Taxable Income of a resident Canadian corporation. However, ITA 113(1) provides a similar deduction for dividends received by a resident corporate shareholder from a foreign affiliate.

20-127. Unlike the fairly straightforward application of ITA 112(1), the application of ITA 113(1) is very complex in that it is applied differently depending on the country where the foreign affiliate is located and income source from which the dividend is being paid. The ITA 113(1) rules are implemented by a process in which the foreign affiliate's Surplus balances are tracked by type of income and source country. We would remind you that the term Surplus in tax work is the equivalent of the term Retained Earnings in accounting work.

20-128. While there are other types of surplus that determine the tax status of dividends from foreign affiliates, in this text we will only provide coverage of Exempt Surplus and Taxable Surplus. Coverage of other surplus balances goes beyond the scope of this introductory text.

20-129. When a dividend is paid by a foreign affiliate it is assumed to come first from any Exempt Surplus balance that is available. If there is no Exempt Surplus balance, or if the dividend is larger than the Exempt Surplus balance, the required amount will then be removed from the Taxable Surplus balance.

## Exempt Vs. Taxable Surplus

20-130. The content of these surplus balances requires the allocation of income from four different sources. They are as follows:

- active business income
- investment income (e.g., interest and rents)
- capital gains on dispositions of assets used to produce active business income
- capital gains on dispositions of assets not used to produce active business income

20-131. The situation is further complicated in that the classification of a particular type of income will depend on whether the foreign affiliate is located in country with which Canada has a tax treaty or a Tax Information Exchange Agreement (TIEA). For example, active business income is allocated to Exempt Surplus in a country where a tax treaty or TIEA is in effect. Alternatively, this type of income is allocated to Taxable Surplus in other countries.

20-132. Based on this two-way allocation, the items included in Exempt Surplus are as follows:

- For a foreign affiliate that is located in a country with which Canada has a tax treaty or a tax information exchange agreement (TIEA):
  - Active business income
  - The taxable one-half of capital gains on dispositions of property used in producing active business income.
- For all foreign affiliates, without regard to the location of the foreign affiliate:
  - The non-taxable one-half of capital gains on dispositions of all types of capital property (except shares of other foreign affiliates).

20-133. Using a similar approach, the items included in Taxable Surplus are as follows:

- For a foreign affiliate that is located in a country with which Canada does not have a tax treaty or a TIEA:
  - Active business income
  - The taxable one-half of capital gains on dispositions of property used in producing active business income.
- For all foreign affiliates, without regard to the location of the foreign affiliate:
  - The taxable one-half of capital gains on dispositions of capital property other than that used in producing active business income.
  - Investment income, which includes income from property and from non-active businesses.

## Dividends Paid From Exempt Surplus

20-134. When a dividend is paid from a foreign affiliate's Exempt Surplus, Canadian tax legislation, in effect, cedes all of the taxation of this income stream to the foreign jurisdiction. This is without regard to the level of local taxation in the foreign jurisdiction or amounts of tax withheld by that jurisdiction.

20-135. In order to apply this approach, ITA 113(1)(a) allows the full amount of the foreign affiliate dividend to be deducted in the determination of the resident corporation's Taxable Income.

> **EXAMPLE** A Canadian company receives a $90,000 dividend from a foreign affiliate. The affiliate had paid a $100,000 dividend from its exempt surplus (an after foreign taxes balance), with the foreign jurisdiction withholding $10,000 from the distribution to Canada.
>
> **ANALYSIS** The Canadian corporation will include the pre-withholding $100,000 dividend in its Net Income For Tax Purposes, and will deduct the $100,000 included amount under ITA 113(1)(a) in the determination of Taxable Income under ITA 113(1)(a). No Canadian taxes will be paid on the dividend and, consistent with this result, no foreign tax credit will be available for the $10,000 that was withheld by the foreign jurisdiction.

### Dividends Paid From Taxable Surplus

20-136. With respect to foreign affiliate dividends paid from Taxable Surplus, the goal here is to apply ITA 113(1) in a manner that attempts to have the overall level of taxation, both domestic and foreign, be the equivalent of the amount of taxes that would be paid in Canada on the same stream of income. Currently this rate is equal to 25 percent.

| | |
|---|---|
| Basic Rate (No Abatement) | 38% |
| General Rate Reduction | (13%) |
| Overall Federal Rate | 25% |

20-137. While this could have been accomplished using credits against Tax Payable, the government chose to do the required adjustments through deductions under ITA 113(1). Given the desire to apply an overall tax rate of 25 percent, tax amounts will have to be converted to income using a factor of 4 (1 ÷ 25%). Stated alternatively, every $1 of tax paid must be converted to Taxable Income of $4.

20-138. To achieve the desired overall tax rate of 25 percent, two adjustments are required:

**ITA 113(1)(b)** adjusts Taxable Income to reflect the income taxes paid in the foreign jurisdiction.

**ITA 113(1)(c)** adjusts Taxable Income to reflect taxes withheld by the foreign jurisdiction on payments to non-residents of that jurisdiction.

20-139. An example will serve to illustrate these provisions.

**EXAMPLE** Cancor, a taxable Canadian corporation, owns 50 percent of the outstanding shares of Forco, a corporation located in a country that does not have a tax treaty or a TIEA with Canada. All of Forco's income is from active business activities. During 2018, Forco pays dividends of $90,000. Of this total, $42,750 is received by Cancor, with $2,250 being withheld by the foreign jurisdiction. Forco is subject to a tax rate of 10 percent in the foreign jurisdiction.

**ANALYSIS** Dividends paid are an after tax amount. This means that the original income stream that formed the basis for the current dividend was $100,000 [$90,000 ÷ (1 - 10%)], with taxes of $10,000 being paid prior to the dividend declaration.

Given this, Cancor's share of these taxes would be $5,000 [(1/2)($10,000)]. Taking this and the $2,250 in withholding into account, to achieve an overall tax rate of 25 percent on the original $50,000 income stream would require additional Canadian taxes as follows:

| | |
|---|---|
| Required Total Tax [(25%)($50,000)] | $12,500 |
| Foreign Taxes Paid By Foreign Affiliate | ( 5,000) |
| Foreign Taxes Withheld From Dividend | ( 2,250) |
| Required Additional Canadian Tax | $ 5,250 |

As we have noted, ITA 113(1) accomplishes this result with two adjustments. The first is related to the $5,000 in foreign tax paid. The $5,000 in taxes paid reflects, at a 25 percent rate, $20,000 ($5,000 ÷ 25%) in Taxable Income. This would suggest multiplying the foreign tax paid by 4. However, this does not take into consideration the fact that income has already been reduced by $5,000 from $50,000 to $45,000 by these taxes. Given this, ITA 113(1)(b) requires that the $5,000 in foreign taxes be multiplied by a relevant factor of 3 [(1 ÷ 25%) - 1]. This deduction equals $15,000.

In applying ITA 113(1)(c), we need to adjust for the $2,250 in taxes withheld from the dividend payment. Given this, ITA 113(1)(c) requires that this amount be multiplied by 4 (1 ÷ 25%). This results in a deduction of $9,000, reflecting the amount of income that would result in the payment of $2,250 in taxes.

Putting all of this together results in the following calculation of Tax Payable:

| | |
|---|---|
| Net Income For Tax Purposes | $45,000 |
| ITA 113(1)(b) Deduction For Foreign Tax Paid | ( 15,000) |
| ITA 113(1)(c) Deduction For Foreign Tax Withheld | ( 9,000) |
| Taxable Income | $21,000 |
| Required Rate | 25% |
| Canadian Tax Payable | $ 5,250 |

This, as expected, is the same amount that we calculated in the preceding table using a more intuitive approach that is not based on the ITA 113 legislation.

## Dividends Received From Controlled Foreign Affiliates

### *Controlled Foreign Affiliate Defined*

20-140. While establishing the concept of a foreign affiliate alleviated the problem of excessive taxation on dividends received by Canadian corporations from non-resident corporations, it did not deal with the problem of using a non-resident corporation to defer Canadian taxation on property income. In order to deal with this issue, the government developed the concept of a "controlled foreign affiliate".

20-141. In somewhat simplified terms, ITA 95(1) defines a controlled foreign affiliate of a Canadian taxpayer as a foreign affiliate of that taxpayer that is:

1. controlled by the Canadian resident on the basis of his own shareholdings; or
2. controlled by the Canadian resident, together with:
   - persons (residents or non-residents) who are not at arm's length with the Canadian resident;
   - up to four Canadian residents who are not related to the taxpayer (referred to as "relevant" shareholders; and
   - any other persons (residents or non-residents) who are related to the "relevant" Canadian shareholders.

**EXAMPLE** Cantext, a Canadian public company, owns 11 percent of the voting shares of Fortext, a company located in Germany. Two other resident Canadian corporations, who are not related to Cantext, each own an additional 15 percent of the voting shares of Fortext. A French subsidiary of one of these other Canadian companies owns 20 percent of the voting shares of Fortext.

**ANALYSIS** Fortext is a foreign affiliate of Cantext since Cantext holds more than 10 percent of the voting shares of Fortext. It is a controlled foreign affiliate in that:

- Cantext owns 11 percent;
- two unrelated Canadian companies (relevant shareholders) own an additional 30 percent; and
- a company related to one of the relevant shareholders owns another 20 percent.

This gives a total holding of 61 percent, enough to provide control of Fortext. Note that Fortext is also a controlled foreign affiliate of both the other Canadian corporations.

20-142. The significance of the controlled foreign affiliate concept is that, if an investment in a non-resident corporation falls within this definition, the Canadian shareholder must recognize its foreign accrual property income (FAPI, hereafter) prior to its actual distribution. That is, the FAPI of controlled foreign affiliates must be recorded as it is earned, rather than when it is distributed in the form of dividends.

20-143. This provision is somewhat mitigated by the fact that Canadian residents are not required to report the FAPI of controlled foreign affiliates unless it exceeds $5,000. The $5,000 exemption figure recognizes that the calculation of FAPI is quite complex and should not be required when the amount of income is small. As FAPI income is taxed as it accrues, dividends subsequently paid out of such income are not taxable.

# Foreign Accrual Property Income (FAPI)

## General Rules

20-144. In simplified terms, FAPI is the passive income of a controlled foreign affiliate. FAPI includes income from property (e.g. interest, portfolio dividends), income from non-active businesses (e.g. rental income), as well as the taxable one-half of capital gains resulting from the disposition of properties that are not used in an active business. An important distinguishing feature of this type of income is that, with the exception of rental income, its source can be easily moved from one tax jurisdiction to another.

20-145. The property income definition for FAPI also includes income from a foreign investment business. This type of business is analogous to the specified investment business that is used in determining income eligible for the small business deduction (see Chapter 12).

20-146. As is the case with the specified investment business rules, a foreign affiliate would be considered to be earning active business income if it either employs more than five full time employees or the equivalent of more than five full time employees, to earn income that would normally be considered property income. This "five-employee" exception is especially important in deciding whether foreign rental income is active (exempt from the FAPI rules) or passive (subject to the FAPI rules).

## Taxation Of FAPI

20-147. As noted in Paragraph 20-142, if a taxpayer has an investment in a controlled foreign affiliate, FAPI must be accrued as it is earned by that affiliate. Note that this is a separate issue from the taxation of dividends from either controlled or other foreign affiliates. We will deal with this latter issue in the next section. Not surprisingly, we will find that if dividends are paid out of FAPI income that has been accrued by a taxpayer, the dividends will not be taxed a second time when received by that investor.

> **EXAMPLE** Paul Peterson, a Canadian resident, owns 80 percent of the shares of Tabasco Ltd., a company that is incorporated in Trinidad. During 2019, the Company has income of $100,000, all of which is earned by passive investments. No income taxes are paid on this income in Trinidad, and no dividends are paid out of this income to Mr. Peterson.
>
> **ANALYSIS** Tabasco Ltd. is clearly a controlled foreign affiliate. Further, all of its income is from passive sources. Given this, under ITA 91(1), Mr. Peterson will have to include $80,000 [(80%)($100,000)] in his Canadian Net Income For Tax Purposes for 2019.

20-148. The preceding example was simplified by the fact that Tabasco Ltd. was not subject to taxes in the foreign country. If it had been, the income of this controlled foreign affiliate would have been subject to double taxation. Fortunately, the *Income Tax Act* provides relief in the form of a deduction under ITA 91(4) that is designed to compensate for foreign taxes that have been paid on FAPI.

20-149. Note that this is a deduction against income, rather than a tax credit. As illustrated in Paragraph 20-120, a deduction against income will reduce Tax Payable only by the amount of the deduction multiplied by the tax rate. This means that its value to the taxpayer is less than the amount of foreign taxes paid and, given this, it would not be equitable to set the deduction equal to those taxes.

20-150. The ITA 91(4) deduction recognizes this difference by multiplying the foreign taxes paid on FAPI by what is referred to as a relevant tax factor (RTF, hereafter). As defined in ITA 95(1), the RTF for individuals is different than it is for corporations.

> **Canadian Resident Individual** If the investor in the controlled foreign affiliate is an individual, the RTF is 1.9. This is based on the notional assumption that the Canadian tax rate on this income would have been about 52.63 percent if the individual had received it from a Canadian source (1 ÷ 52.63% = 1.9).

**Canadian Resident Corporation** If the investor in the controlled foreign affiliate is a corporation, the RTF is 4. This RTF is based on 1, divided by a notional tax rate that would have applied if the income had been received from a Canadian source (1 ÷ 25% = 4). That rate of 25 percent is 38 percent, less the General Rate Reduction of 13 percent. Note again, that because foreign income is involved, the 10 percent federal tax abatement is not deducted.

20-151. If the controlled foreign affiliate's income is taxed in the foreign jurisdiction at the notional rate applicable to the investor, the ITA 91(4) deduction will completely eliminate the FAPI. In most cases, the foreign tax rate will be below the notional rates, resulting in some FAPI being included in income. Note, however, that the ITA 91(4) deduction cannot exceed the FAPI.

**EXAMPLE CONTINUED (Foreign Taxes Paid)** Paul Peterson, a Canadian resident, owns 80 percent of the shares of Tabasco Ltd., a company that is incorporated in Trinidad. During 2019, the Company has income of $100,000, all of which is earned by passive investments. The Company pays Trinidadian taxes at a rate of 20 percent. No dividends are paid out of this income to Mr. Peterson.

**ANALYSIS** The tax consequences to Mr. Peterson would be as follows:

| | |
|---|---|
| FAPI [(80%)($100,000)] | $80,000 |
| Deduct Lesser Of: | |
| • FAPI = $80,000 | |
| • ITA 91(4) Deduction [(1.9)(80%)(20%)($100,000)] = $30,400 | ( 30,400) |
| Addition To Net Income For Tax Purposes | $49,600 |

## Exercise Twenty - 14

**Subject:** FAPI

Forco is a wholly owned foreign subsidiary of Canco, a resident Canadian company. Forco earns $100,000 of investment income in 2019 and pays 18 percent in tax in the foreign jurisdiction. None of the after tax income is paid out as dividends. What is the effect of this information on Canco's 2019 Net Income For Tax Purposes?

**SOLUTION available in print and online Study Guide.**

### Dividends From FAPI

20-152. A final problem remains when the controlled foreign affiliate subsequently distributes the FAPI to the Canadian resident shareholders as a dividend. While these dividends must be included in income, the *Income Tax Act* provides a deduction to reflect the fact that all or a part of the dividend may have already been taxed in an earlier year as FAPI.

20-153. The deduction is provided solely through ITA 91(5) in the case of individuals and a combination of ITA 91(5) and ITA 113(1)(b) in the case of corporations. The deductions are designed to eliminate taxation on previously taxed FAPI. It is equal to the lesser of the dividends received and the FAPI previously taxed to that shareholder after the ITA 91(4) deduction. Any withholding taxes on dividends paid to corporate shareholders of foreign affiliates are eligible for a deduction under ITA 113(1)(c). (See Paragraph 20-138.)

**EXAMPLE CONTINUED (Dividend Paid)** Paul Peterson, a Canadian resident, owns 80 percent of the shares of Tabasco Ltd., a company that is incorporated in Trinidad. During 2019, the Company has income of $100,000, all of which is earned by passive investments. The Company pays Trinidadian taxes at a rate of 20 percent. Tabasco Ltd. declares and pays dividends of $40,000 in January, 2020. There is no withholding tax on this dividend.

**ANALYSIS** As shown in Paragraph 20-151, Mr. Peterson's addition to Net Income For Tax Purposes in 2019 was $49,600. The consequences of receiving the dividend in 2020 would be nil as shown in the following calculation.

| | |
|---|---|
| Foreign Source Dividend [(80%)($40,000)] | $32,000 |
| Deduct Lesser Of: | |
| • Previous FAPI After ITA 91(4) Deduction = $49,600 | |
| • Dividend Received = $32,000 | ( 32,000) |
| Addition To Net Income For Tax Purposes | Nil |

## Exercise Twenty - 15

**Subject**: Dividends From FAPI (An Extension Of Exercise Twenty - 14)

Forco is a wholly owned foreign subsidiary of Canco, a resident Canadian company. Forco earns $100,000 of investment income in 2019 and pays 18 percent in tax in the foreign jurisdiction. In 2020, Forco distributes its net after-tax FAPI of $82,000 to Canco as a dividend. Assume that there are no withholding taxes on the dividend payment. What is the effect of this information on Canco's 2020 Net Income For Tax Purposes?

**SOLUTION available in print and online Study Guide.**

**We suggest you work Self Study Problem Twenty-7 at this point.**

**Additional Supplementary Self Study Problems Are Available Online.**

# Key Terms Used In This Chapter

20-154. The following is a list of the key terms used in this Chapter. These terms, and their meanings, are compiled in the Glossary located at the back of the Study Guide.

Business Income
Capital Gain
Controlled Foreign Affiliate
Dividends
Double Taxation
Employment Income
Exempt Surplus
Foreign Accrual Property Income (FAPI)
Foreign Affiliate
Interest Income
International Tax Treaty
(a.k.a., International Tax Convention)
International Taxation
Non-Resident
Permanent Establishment
Person
Resident
Sojourner
Tax Haven
Taxable Canadian Property
Taxable Surplus

# References

20-155. For more detailed study of the material in this Chapter, we would refer you to the following:

| | |
|---|---|
| ITA 2(3) | Tax Payable By Non-Resident Persons |
| ITA 20(11) | Foreign Taxes On Income From Property Exceeding 15 Percent |
| ITA 90 | Dividends Received From Non-Resident Corporation |
| ITA 91 | Amounts To Be Included In Respect Of Share Of Foreign Affiliate |
| ITA 94 | Application Of Certain Provisions To Trusts Not Resident In Canada |
| ITA 95 | Definitions [Foreign Accrual Property Income] |
| ITA 113 | Deduction In Respect Of Dividend Received From Foreign Affiliate |
| ITA 115 | Non-Resident's Taxable Income In Canada |
| ITA 116 | Disposition By Non-Resident Person Of Certain Property |
| ITA 118.94 | Tax Payable By Non-Resident (Tax Credits) |
| ITA 126 | Foreign Tax Credits |
| ITA 212 | Tax On Income From Canada Of Non-Resident Persons (Section in ITA Part XIII which deals with Canadian property income of non-resident persons.) |
| ITA 216 | Alternatives Re Rents And Timber Royalties |
| ITA 217 | Alternative Re Canadian Benefits |
| ITA 248(1) | Definitions (Taxable Canadian Property) |
| ITA 249 | Definition Of "Taxation Year" |
| ITA 253 | Extended Meaning Of "Carrying On Business" |
| | |
| IC 72-17R6 | Procedures Concerning The Disposition Of Taxable Canadian Property By Non-Residents Of Canada - Section 116 |
| IC 75-6R2 | Required Withholding from Amounts Paid to Non-Resident Persons Performing Services in Canada |
| IC 76-12R6 | Applicable Rate of Part XIII Tax on Amounts Paid or Credited to Persons in Countries With Which Canada Has a Tax Convention |
| IC 77-16R4 | Non-Resident Income Tax |
| | |
| S5-F2-C1 | Foreign Tax Credit |
| | |
| IT-137R3 | Additional Tax On Certain Corporations Carrying On Business In Canada |
| IT-173R2 | Capital Gains Derived In Canada By Residents Of The United States |
| IT-176R2 | Taxable Canadian Property - Interests In And Options On Real Property And Shares |
| IT-262R2 | Losses Of Non-Residents And Part-Year Residents |
| IT-303 | Know-How And Similar Payments To Non-Residents |
| IT-420R3 | Non-Residents - Income Earned In Canada |
| IT-451R | Deemed Disposition And Acquisition On Ceasing To Be Or Becoming Resident In Canada |
| IT-465R | Non-Resident Beneficiaries Of Trusts |
| IT-468R | Management Or Administration Fees Paid To Non-Residents |
| IT-497R4 | Overseas Employment Tax Credit |

## Problems For Self Study (Online)

To provide practice in problem solving, there are Self Study and Supplementary Self Study problems available on MyLab Accounting.

Within the text we have provided an indication of when it would be appropriate to work each Self Study problem. The detailed solutions for Self Study problems can be found in the print and online Study Guide.

We provide the Supplementary Self Study problems for those who would like additional practice in problem solving. The detailed solutions for the Supplementary Self Study problems are available online, not in the Study Guide.

The .PDF file "Self Study Problems for Volume 2" on MyLab contains the following for Chapter 20:

- 7 Self Study problems,
- 3 Supplementary Self Study problems, and
- detailed solutions for the Supplementary Self Study problems.

## Assignment Problems

(The solutions for these problems are only available in the solutions manual that has been provided to your instructor.)

### Assignment Problem Twenty - 1

#### (Part I Tax On Non-Residents)

The following material describes six independent cases which involve U.S. citizens or U.S. companies that have some type of Canadian source income.

#### Case 1

Flager is a U.S. based manufacturing company. To facilitate Canadian sales, the company ships its product to a warehouse located in Moncton, New Brunswick. The warehouse is rented on a monthly basis, with a clause in the lease that allows cancellation on 90 days notice.

Flager has made an arrangement with Jack Martin to sell their products in the Maritime provinces. Jack works out of an office in his home. He does not have authority to conclude individual sales contracts without approval from the head office in the U.S.

#### Case 2

Flager is a U.S. based manufacturing company. To facilitate Canadian sales, the company ships its product to a warehouse located in Moncton, New Brunswick. The warehouse is rented on a monthly basis, with a clause in the lease that allows cancellation on 90 days notice.

Flager has made an arrangement with Jack Martin to sell their products in the Maritime provinces. Jack works out of a large office in the warehouse, which takes up a considerable portion of the total floor space. He has the authority to conclude individual sales contracts without approval from the U.S. head office.

#### Case 3

Genevieve Boulud is a U.S. citizen and a resident of that country. Because she speaks fluent French, her U.S. based employer transfers her to an affiliate's Montreal office for 4 months. She has employment income during this period of $36,000 US, all of which is paid by her U.S. employer.

### *Case 4*

Ruby Nash is a U.S. citizen and a resident of that country. During the current year she accepts an employment contract which requires her to work in Calgary for a period of 3 months. Her salary is $11,000 Cdn per month. The contract is with a Canadian corporation that is responsible for paying the salary.

### *Case 5*

Ada Taylor is a U.S. citizen and a resident of that country. She owns all of the shares in a U.S. based private company that was incorporated in the U.S. This corporation's only activity is buying and operating vacation rental properties in Canada. In order to support her increasingly decadent lifestyle, she sells all of the shares in this company during the current year. She realizes a gain on this sale of $250,000.

### *Case 6*

Cynthia Edwards is a U.S. citizen and a resident of that country. She is a minority shareholder of a Canadian controlled private corporation. This corporation's only activity is buying and operating rental properties in major Canadian cities. Because of her concern about the inflated prices in both Toronto and Vancouver, she sells her shares in the company during the current year. The sale results in a total gain of $785,000.

**Required:** For each case, indicate whether the non-resident would be subject to Part I Canadian income tax.

## *Assignment Problem Twenty - 2*

### *(Permanent Establishments)*

A U.S. manufacturer of furniture is considering entering the Canadian market. The company will use one of the following approaches to expand its market in Canada:

A. Direct sales to wholesalers by full-time salespeople who report to a sales office in each of three Canadian provinces. The sales offices will co-ordinate marketing and shipping of products from two warehouses located in Canada. However, formal approval of contracts will be administered in the U.S. head office.

B. The sales offices described in Part A would be independent profit centres, with regional credit managers. The two warehouses from which orders are filled will be near the sales offices.

C. Company online sales territory would be expanded to include shipping to Canada.

D. Direct sales to wholesalers by non-exclusive agents. The agents will represent other suppliers as well.

E. Direct sales to wholesalers by full-time salespeople in each of three Canadian provinces. No sales offices will be opened, and the furniture will be shipped from a warehouse in the U.S. Shipment will be made only after a customer's credit and contract are approved by the U.S. head office.

F. Selling furniture to Canadian distributors. The distributors pay the shipping costs on the furniture from the U.S. port or border crossing closest to them.

**Required**: For each market expansion approach, assess whether or not the U.S. manufacturer will be deemed to have a permanent establishment in Canada. Justify your conclusion and identify any other information required to support your position.

### Assignment Problem Twenty - 3

#### (Part XIII Tax On Non-Residents)

Each of the following independent cases involves a non-resident individual who has Canadian source income during the current year. All amounts are in Canadian dollars.

**Case A**

Martha Martin is a resident of the United States. She owns debt securities that were issued by a Canadian public company. The interest rate on the securities is determined by the level of profits earned by the company. During the current year, she receives interest of $2,460.

**Case B**

Brendan Lee is a resident of a country that does not have a tax treaty with Canada. He is the owner of a vacation property in northern Ontario that he rents to Canadian residents. His gross rents for the current year are $94,000. Expenses related to the property, including maximum CCA, are $27,000.

**Case C**

Barry Fox is a resident of a country that does not have a tax treaty with Canada. He owns debt securities issued by a Canadian company that pay interest at a rate that is determined by the profits of the company. During the current year, he receives interest of $4,680 from this investment.

**Case D**

Terence Redux is a resident of a country that does not have a tax treaty with Canada. During the current year he earns $2,685 of interest on a savings account in Canada.

**Case E**

Karl Marks is a resident of a country that does not have a tax treaty with Canada. During the current year, Karl receives $8,462 in dividends from a Canadian private company. Karl owns 20 percent of this company's voting shares.

**Required:** For each of these situations, indicate how the Canadian source income would be taxed under Canadian tax legislation. Explain your conclusion.

### Assignment Problem Twenty - 4

#### (Emigration - Tax Planning)

Harlen Holt, a resident of Nova Scotia, plans to emigrate from Canada on December 31, 2019. On that date, he will own the following assets:

**Automobile** Harlen owns a BMW 750 which cost $135,000. Its fair market value on December 31, 2019 is $52,000.

**RRSP** The December 31 balance in Harlen's RRSP is $973,000.

**Shares In Public Companies** Harlen owns a portfolio of publicly traded shares which have a total adjusted cost base of $460,000. Their fair market value on December 31, 2019 totals $535,000.

**Shares In A CCPC** Harlen is a minority shareholder of a CCPC. The CCPC owns and operates five apartment buildings. More than 80 percent of the fair market value of the shares is derived from the value of these buildings. The adjusted cost base of these shares is $287,000 and they have a December 31, 2019 fair market value of $300,000.

**Residence** This property was purchased for $430,000, including $150,000 for the land. Its fair market value on December 31, 2019 is $540,000, including $200,000 for the land.

**Cottage** This property was purchased for $345,000, including $95,000 for the land. Because a large nearby development has flooded the market with low price units, it has a fair market value on December 31, 2019 of $300,000, including a value for the land of $50,000. Harlen has rented out this property since its purchase and reported a small rental income every year. He has never taken CCA on the property.

**Savings Account** The balance in this account is $45,600.

**Required:**

A. For each of the listed assets, indicate the tax consequences, including any amounts of deferred income, that would result from Harlen's emigration from Canada. Assume that he does not make any elections at the time of his move. Ignore the lifetime capital gains deduction.

B. Under ITA 128.1(4)(d), taxpayers can elect to have a deemed disposition on certain assets where a deemed disposition is not automatic. Determine if Harlen could use this election to minimize his tax obligation at the time of his departure. If he can, calculate the amount of the reduction in Net Income For Tax Purposes that would result from the use of this election.

## Assignment Problem Twenty - 5

### (Comprehensive Review Problem - Residency Of Individuals)

**Note** This problem covers material from several other Chapters of the text.

Elaine Brock is a very successful marketing manager for a multi-national corporation based in the United States. While she has always been a Canadian resident, working out of the corporation's Toronto office, she has been offered a promotion that would require that she relocate to Tampa, Florida. As this is intended to be a permanent change, Elaine has applied for and received the documentation that will allow her to live and work in the United States. She will be moving to Tampa on July 1, 2019.

The corporation provides a $40,000 moving allowance that will be paid by the Toronto office prior to her move. While the corporation does not require documentation of this amount, Elaine estimates that she will incur $32,000 in actual moving costs.

Her common-law partner, Marion Davies, is a very popular singer and songwriter. Marion has also received documentation that will allow her to live and work in the United States. However, she is currently writing songs to complete a new album in her Toronto music studio and is not planning to join Elaine until early 2020.

The state of Florida does not assess a state income tax on its residents, largely because of the high level of tax revenues generated by Disney World. Assume that the marginal federal (U.S.) rate for Elaine would be 35 percent. This rate would only be applied to income earned in the United States.

On July 1, 2019, the date that Elaine departs for Tampa, she owns the following assets:

| Description | Date Acquired | Original Cost | Fair Market Value |
|---|---|---|---|
| Registered Retirement Savings Plan | N/A | $235,000 | $452,000 |
| Canadian Paintings* | Various | 125,000 | 232,000 |
| Condo Residence In Toronto | 2006 | 360,000 | 480,000 |
| Huntsville Cottage | 2009 | 225,000 | 175,000 |
| Automobile | 2014 | 85,000 | 62,000 |
| Sailboat | 2016 | 28,000 | 32,000 |
| Shares In Brock Inc., A CCPC | 2004 | 98,000 | 156,000 |
| Shares In Bank Of Nova Scotia | 2012 | 56,000 | 85,000 |

*None of the paintings had an adjusted cost base or a fair market value that was less than $1,000.

Elaine owns 100 percent of the real property. She has rented out the cottage since its purchase and reported a small rental income every year. She has never taken CCA on the property. The loss in value is related only to the land as the waterfront has been severely damaged by flooding. The value of the land has decreased from $130,000 at purchase to $80,000.

While Elaine intends to sell all of the other assets fairly soon, she plans on renting both the Toronto residence and Huntsville cottage for at least 3 years.

**Required**: Explain to Elaine the tax consequences of her move to the United States. Assume that:

- Elaine ceases to be a Canadian resident when she departs on July 1, 2019.
- Any additional income that Elaine earns in 2019 while a resident of Canada will be taxed in Canada at a combined federal/provincial rate of 47 percent.

In addition, advise Elaine as to any tax planning opportunities to minimize her Canadian Tax Payable for the current and future years. Ignore the lifetime capital gains deduction.

## Assignment Problem Twenty - 6

### (Foreign Investment Reporting Rules)

The following six Cases are independent. Each involves a Canadian taxpayer who does not hold any other foreign investments. All listed amounts are in Canadian dollars.

For each asset, indicate whether the foreign investment reporting rules are applicable.

1. A cottage in Woodstock, Vermont, purchased for $365,000, with a down payment of $65,000 and the assumption of a $400,000 mortgage. The cottage is used by the taxpayer and his extended family throughout the year.
2. A building in Canton, Ohio, with a cost of $1,560,000, is owned by a Canadian corporation. It is used exclusively to store the Company's products for distribution.
3. Shares in a U.S. public company with a cost of $286,000 and a current fair market value of $72,000. One-half of these shares were purchased in the taxpayer's Canadian brokerage trading account and the other half were purchased in the taxpayer's self-directed RRSP.
4. A U.S. bank account and a mortgage resulting from the sale of a rental property to a U.S. resident three years ago. The original amount of the mortgage was $135,000. However, the amount owing at the beginning of the current year is $68,000. The taxpayer's bank account in a U.S. bank has a balance of between $3,000 and $12,000 throughout the year.
5. A yacht with a cost of $1,300,000 which was purchased and is docked in San Diego, California. The yacht is used by a Vancouver taxpayer as a venue for her lavish parties.
6. A condo in Fort Meyers, Florida is purchased for $860,000. The condo is rented to Canadians for 9 months of the year and used by the taxpayer the remaining 3 months.

## Assignment Problem Twenty - 7

### (Foreign Source Investment Income And T1135)

Vickey Gateley works and resides in Niagara Falls, Ontario. A long time monarchist, she has developed a well diversified portfolio of stocks of British companies. At December 31, 2019, Ms. Gateley is holding British stocks with a cost of £800,000. She also has a British bank account with a London bank that has a balance that fluctuates between £25,000 and £50,000.

One of her boyfriends lives in Buffalo, New York. Three years ago, when she started spending many of her weekends there, she decided to purchase a condo in Buffalo. Because the building she chose had construction problems, the prices were depressed and she purchased four units for US$200,000 each. She has rented out the other three units.

During 2019, she earned the following amounts of investment income:

| | |
|---|---|
| Dividends From British Public Corporations<br>Net Of 15 Percent Withholding | £54,400 |
| Interest On Bank Account | £ 1,300 |
| Gross Rental Income From Rental Properties | US$86,000 |
| Expenses Of Operating Rental Properties | US$45,000 |

**Other Information**

1. Ms. Gateley has left the interest in her British bank account and has not transferred it to Canada.
2. Ms. Gateley believes her condo units are very undervalued. Because of her concern with respect to future recapture, she does not take CCA on her rental properties.
3. The dividends from the British corporations were paid on a quarterly basis.
4. Assume that the exchange rates throughout 2019 were £1 = $1.70 and US$1 = Cdn$1.30.

**Required:**

A. Indicate the amounts of investment income that would be included in Ms. Gateley's 2019 Net Income For Tax Purposes, as well as any tax credits that would be available to Ms. Gateley to offset this income.

B. Is Ms. Gateley required to file a T1135? If yes, what assets have to be included? The detailed reporting needed on the assets is not required.

### *Assignment Problem Twenty - 8*

### *(Foreign Source Dividends Received By An Individual)*

Matthew Fortin is a Canadian resident who lives in London, Ontario. During the year ending December 31, 2019, he has the following sources of income:

| | |
|---|---|
| Net Employment Income | $121,300 |
| Taxable Capital Gains | 11,400 |
| Dividends From Canadian Public Companies | 27,350 |
| Dividends From Foreign Companies: | |
| Country One - Saxon Ltd. (Before Withholding Of $8,000) | 40,000 |
| Country Two - Selena Ltd. (Before Withholding Of $1,800) | 18,000 |

His business and investment activities have been unsuccessful in previous years and, as a consequence, he has the following amounts available for reducing his 2019 Taxable Income:

| | |
|---|---|
| Net Capital Loss Carry Forward | $16,760 |
| Business Loss Carry Forward | 13,480 |

His only tax credits are the basic personal credit, employment related credits, and any credits related to the dividends received.

**Required:** Determine Matthew's Federal Tax Payable for the year ending December 31, 2019.

### Assignment Problem Twenty - 9

#### (Taxation Of Foreign Affiliate Dividends)

CTP is a Canadian public corporation that has acquired 15 percent of the shares of FTP, a corporation that is established in a foreign country. During the year ending December 31, 2018, FTP earns $20,000 in investment income, $70,000 from an active business and $20,000 of capital gains from the sale of investment assets.

In early 2019, FTP distributes all of its 2018 after tax income as a dividend to its shareholders. FTP has no additional income in 2019.

In both 2018 and 2019, CTP is subject to a federal tax rate of 25 percent.

The following Cases make use of the preceding information. However, the individual Cases make various additional or alternative assumptions.

**Required:** Provide the information that is requested in each of the following Cases.

**Case 1** FTP is a non-controlled foreign affiliate of CTP. Assume that it is located in a country that does not have a tax treaty or a TIEA with Canada, that this country does not assess income taxes on corporations and does not assess withholding taxes on dividend payments to non-residents. What are the tax consequences for CTP resulting from its investment in FTP during 2018 and 2019? Include the increase in Net Income For Tax Purposes and total Taxes Payable for both years in your solution.

**Case 2** Assume the same facts as in Case 1, except that FTP is a controlled foreign affiliate of CTP. How would the tax consequences for CTP differ from the tax consequences described in Case 1, for 2018 and 2019?

**Case 3** Assume the same facts as in Case 1, except that FTP is not a foreign affiliate of CTP. How would the tax consequences for CTP differ from the tax consequences described in Case 1, for 2018 and 2019?

**Case 4** Assume the same facts as in Case 1, except that FTP is located in a country that has a tax treaty with Canada. How would the tax consequences for CTP differ from the tax consequences described in Case 1, for 2018 and 2019?

**Case 5** FTP is a non-controlled foreign affiliate of CTP. Assume that FTP is located in a country that has a tax treaty with Canada, that this country assesses income taxes on active business income at a rate of 10 percent and does not assess withholding taxes on dividend payments to non-residents. The income taxes paid by FTP in the foreign country total $7,000 [(10%)($70,000)]. What are the tax consequences for CTP resulting from its investment in FTP during 2018 and 2019?

**Case 6** Assume the same facts as in Case 5, except that the foreign country levies the 10 percent income tax on all of FTP's 2018 income. This income tax would total $11,000 [(10%)($110,000)]. In addition, a further 8 percent withholding tax of $7,920 [(8%)($110,000 - $11,000)] was assessed on the dividend paid in 2019. The resulting dividend payment was $91,080 ($110,000 - $11,000 - $7,920). What are the tax consequences for CTP resulting from its investment in FTP during 2018 and 2019?

### Assignment Problem Twenty - 10

#### (Canadian Source Income - Short Cases)

#### Case A

Mr. Jack Holt is an employee of Stillwell Industries, an American manufacturing Company. During the period June 15 through December 6 of the current year, Mr. Holt worked in Canada providing technical assistance to a Canadian subsidiary of Stillwell Industries. His salary was U.S. $5,500 per month. During the period that Mr. Holt was in Canada, Stillwell Industries continued to deposit his salary into his normal U.S. bank account. Both his salary for this period and all of his related travelling expenses were billed to the Canadian subsidiary.

**Required:** Explain Mr. Holt's tax position.

#### Case B

Mr. John McQueen was for many years a resident of Ontario. On his retirement ten years ago, he returned to his native Scotland and has not since returned to Canada. However, he has retained considerable investments in Canada, as follows:

- **Common Stocks** He has a large portfolio of common stocks that are registered in the name of his Toronto broker. The broker receives all dividends and periodically sends a cheque to Mr. McQueen in Scotland.
- **Mortgage Portfolio** He has a large portfolio of second mortgages. All collections on these mortgages are made by a Toronto law firm and are deposited into a Toronto bank account in the name of Mr. McQueen.

**Required:** Who is responsible for tax withholdings under Part XIII of the *Income Tax Act*, and on which amounts must withholdings be made?

#### Case C

Hotels International is a U.S. corporation with hotel properties throughout the world. It has recently developed a property in Nova Scotia that will open during the current year. A long-term management lease has been signed with Hotel Operators Ltd., a Canadian company specializing in the management of hotels. Under the terms of the lease, Hotel Operators Ltd. will pay all of the operating expenses of the hotel and, in addition, make an annual lease payment of $1,250,000 to the American owners of the new hotel.

**Required:** Will the U.S. corporation, Hotels International, be subject to Canadian income taxes on the annual lease payment, and, if so, to what extent?

#### Case D

The Maple Company, a public company resident in Canada, has 2,400,000 shares of its no par common stock outstanding. Sixty percent of these shares are owned by its American parent, the Condor Company. The remaining shares are owned by Canadian residents. In addition to the common shares, the Condor Company holds all of an outstanding issue of Maple Company debenture bonds. Two of the five directors of the Maple Company are Canadian residents, while the remaining three are residents of the United States. During the current year, the Maple Company paid a dividend of $1 per share on its common stock and interest of $900,000 on its outstanding debenture bonds.

**Required:** Calculate the amount of Part XIII taxes to be withheld by the Maple Company with respect to the interest and dividend payments to its American parent.

# CHAPTER 21

# GST/HST

## Introduction

### Background

#### *Introduction Of The GST*

21-1. After significant controversy, a goods and services tax (GST, hereafter) was introduced in Canada on January 1, 1991. This broadly based, multi-stage transaction tax replaced the more narrowly focused federal sales tax on manufactured goods. The GST was originally introduced at a rate of 7 percent. However, this rate was reduced to 6 percent in 2006, with a further reduction to 5 percent on January 1, 2008. There have been no other GST rate changes implemented or proposed since that date.

21-2. The concept underlying this tax was that it would be applied in an even-handed manner to all goods and service transactions. However, tax policy is often more influenced by political considerations than it is by economic logic. As a result, by the time the tax was actually introduced, it was burdened by a complex web of exemptions and modifications that significantly increased the cost of compliance.

21-3. The developers of this tax also hoped that the provinces would be willing to amalgamate their provincial sales taxes with the federal GST in order to provide taxpayers with a uniform national approach to the taxation of goods and service transactions. This could have resulted in very substantial savings in both compliance costs and administrative costs. This, however, did not happen.

21-4. Only the province of Quebec showed any early signs of cooperation in this area. The provinces of Alberta, British Columbia, and Ontario initially took legal action against the federal government, claiming that the GST was unconstitutional. In 1992, Quebec introduced the Quebec Sales Tax (QST), a similar, but not identical transaction tax. As part of this process, it was agreed that both the QST and all GST collected in Quebec would be administered by the province of Quebec.

#### *Harmonized Sales Tax (HST)*

21-5. The GST situation did not change until 1997, when three of the Atlantic provinces, New Brunswick, Nova Scotia, and Newfoundland implemented a harmonized sales tax (HST, hereafter) that contained both a federal and a provincial tax component. In the harmonization process, these provinces eliminated their separate provincial sales taxes.

21-6. The harmonized sales tax is, in effect, a combination of the 5 percent GST rate and a provincial rate that varies from 8 to 10 percent. This gives overall rates of 13 to 15 percent. Since its initial introduction in New Brunswick, Nova Scotia, and Newfoundland, both Ontario and Prince Edward have become participants in the system. British Columbia joined and then, after a bitterly fought referendum, returned to a GST/PST system.

21-7. A major advantage of the HST system is that it is administered by the federal government, eliminating the need for the dual administrative system that is required in those provinces that collect both GST and PST. This does not, however, eliminate flexibility at the provincial level. This is evidenced by the differences in the provincial tax component rate, as well as by different rebates on the provincial portion of the HST for a number of items.

## The Current Situation

21-8. These developments have left Canada with a somewhat cluttered transaction tax landscape. The various arrangements are summarized in the following Figure 21-1:

**Figure 21 - 1**
**Transaction Taxes In Canada As At July 1, 2019**

| Type Of Tax | Province | Rates | Tax Administration |
|---|---|---|---|
| GST Only | Alberta | 5% + 0% | Federal |
| GST and PST | British Columbia | 5% + 7% | Federal and Provincial |
| | Manitoba: | | |
| | - to June 30, 2019 | 5% + 8% | Federal and Provincial |
| | - starting July 1, 2019 | 5% + 7% | Federal and Provincial |
| | Saskatchewan | 5% + 6% | Federal and Provincial |
| HST | New Brunswick | 15% | Federal |
| | Newfoundland | 15% | Federal |
| | Nova Scotia | 15% | Federal |
| | Ontario | 13% | Federal |
| | Prince Edward Island | 15% | Federal |
| GST and QST | Quebec | 5% + 9.975% | Provincial |

21-9. This table illustrates some of the complexity of the current situation resulting from the use of different rates and regimes applying those rates. This is further complicated by the fact that in the HST provinces, rebates of the provincial portion of the tax are provided on some items in some provinces, but not others.

21-10. It is obvious that the transaction tax situation in Canada is extremely complex due to the use of different systems ( GST only, GST plus PST, and HST), the use of different provincial rates, and the use of different provincial rebates on various classes of goods. It is not surprising that this can result in very high compliance costs for businesses.

## How This Text Deals With This Complexity

21-11. It is clearly not appropriate in a general textbook on taxation to attempt detailed coverage of the GST and HST procedures applicable in each province. It is likely that an attempt to do this would require a completely separate third volume.

21-12. The GST is applicable to all provinces either as a separate tax or as a component of HST. Fortunately, many of the provisions for the HST are identical to those for the GST. This means that, in general, the concepts and procedures involved are the same for both the GST and the HST.

21-13. Given this situation, our discussion and examples will focus on one of two scenarios:

- Situations where only the GST is applicable. Alberta is the only province where this situation applies. However, it is also applicable in the three territorial jurisdictions.
- Situations where the HST is applicable.

21-14. We will not use examples involving those provinces where both GST and PST are in effect, nor will attention be given to the unique situation in Quebec.

21-15. With the exceptions of a brief Chapter 3 discussion of the GST component of employee benefits and a limited presentation on the impact of the GST on business income, all of our material on GST is included in this Chapter. This includes consideration of the Employee And Partner GST Rebate, as well as the application of GST to the purchase and sale of capital assets. We have also included GST procedures and administration in this chapter, rather than in Chapter 2.

21-16. We view this as an extremely important subject. The great majority of businesses in Canada file GST returns. In addition, many organizations, such as charities and unincorporated businesses must file GST returns, even though they are not required to file income tax returns. Given the pervasiveness of this tax and the amounts that can be involved, it is our view that some understanding of its application is an essential component of the knowledge base of every professional accountant and businessperson.

# Transaction Tax Concepts

## General Description

21-17. While taxes like the GST and HST are often referred to as commodity taxes, the title is not appropriate as the term commodity does not include services. When both goods and services are subject to a tax, what we are really concerned with is the taxation of transactions as opposed to the taxation of income.

21-18. In both Canada and the U.S., the bulk of federal tax revenues has traditionally been generated by taxes on personal and corporate income. However, transaction taxes have been widely used in both countries at the provincial or state level. In addition, there has been a worldwide trend towards increased use of transaction taxes, with many industrialized countries now relying heavily on this type of taxation.

21-19. Some of the factors that support the increased use of transaction taxes are as follows:

- **Simplicity** Transaction taxes are easy to administer and collect. No forms are required from individuals paying the tax and, if the individual wishes to acquire a particular good or service, it is difficult to legally evade payment.
- **Incentives To Work** An often cited disadvantage of income taxes is that they can discourage individual initiative to work and invest. Transaction taxes do not have this characteristic.
- **Consistency** Transaction taxes avoid the fluctuating income and family unit problems that are associated with progressive income tax systems.
- **Keeping The Tax Revenues In Canada** While some types of income can be moved out of Canada, resulting in the related taxes being paid in a different jurisdiction, taxes on Canadian transactions remain with Canadian taxing entities.

21-20. Given these advantages for transaction taxes, why is income taxation still used? The answer to this question largely involves the question of fairness. In general, transaction taxes relate to consumption. When this is combined with the fact that lower income individuals usually spend a larger portion of their total income on consumption, transaction taxes are assessed at higher effective rates on individuals with lower incomes. Using more technical terminology, transaction taxes are usually regressive.

21-21. This is in conflict with the widely held belief that fairness requires that individuals with higher incomes should have their income taxed at higher average rates. This goal is best accomplished through the continued use of a progressive income tax system.

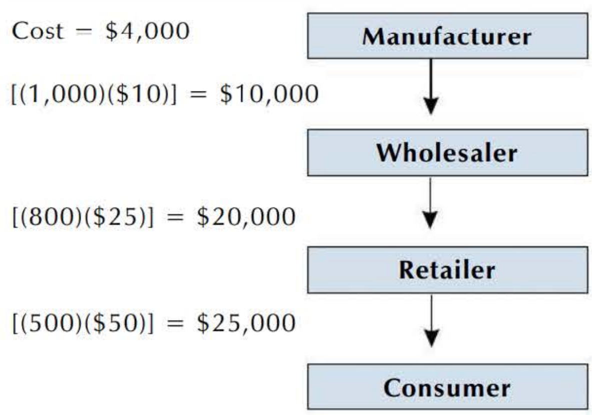
21-22. The federal government has compensated for the regressive nature of the GST by providing a GST tax credit that is available to low income individuals who file income tax returns. Similar provisions are available at the provincial level where HST is applicable.

21-23. There are a number of different ways in which transaction taxes can be applied. We believe that it is useful to understand how the Canadian system compares with the various alternatives that are in use in other jurisdictions. These alternatives will be given consideration in the next section of this Chapter.

## Example

21-24. In discussing the various approaches that can be used in the application of transaction taxes, a simple example is useful. Such an example is diagramed in Figure 21-2. As can be seen in Figure 21-2, our example involves a manufacturer who produces 1,000 units of product at a cost of $4 of raw materials per unit, a total cost of $4,000. All of the 1,000 units are sold to a wholesaler for $10 per unit. The wholesaler then sells 800 of the units to a retailer for $25 per unit. The retailer, in turn, sells 500 of the units to a consumer for $50 per unit.

**Figure 21 - 2**
**Transaction Tax Example**




## Single Stage Transaction Taxes - Retail Sales Tax

21-25. A single stage transaction tax could be applied at any level in this example. The most common type of single stage tax is applied at the consumer level. This would be the familiar retail sales tax that is collected in several Canadian provinces. For example, if the transactions depicted in Figure 21-2 took place in Manitoba, an 8 percent retail sales tax would be assessed on the $25,000 price that the retailer charged the consumer, resulting in a provincial sales tax of $2,000 being paid by the consumer.

21-26. The consumer level is probably the most appropriate level to apply a single stage transaction tax. The tax is visible and its incidence is relatively clear. In contrast, when a wholesale or manufacturer's tax is used, complications can arise when business relationships are formed that blur the lines between the manufacturing, wholesale, and retail levels. This can occur with vertical integration, and necessitates estimates or notional values for transfers between the manufacturing, wholesale, or retail levels of an organization.

## Multi-Stage Transaction Taxes - Turnover Tax

21-27. Again referring to Figure 21-2, it would be possible to impose a multi-stage transaction tax at any combination of the various levels depicted. For example, the tax could be applied at the wholesale and retail levels, without application at the manufacturing level. Alternatively, the manufacturing and wholesale levels could be taxed without application at the retail level. An extension of this taxation to all levels is sometimes referred to as a turnover tax, with transactions being taxed at all levels in the distribution chain.

21-28. The problem with such a turnover tax is that it involves the pyramiding of taxes when there is no credit for taxes paid earlier in the chain. For example, if there was a 5 percent turnover tax in place, the manufacturer in Figure 21-2 would charge the wholesaler $10.50 per unit. When the wholesaler applies his normal markup of 250 percent of cost ($25 ÷ $10), the price would be $26.25 per unit [($10.50)(2.5)]. Of this $26.25, $0.025 [($0.50)(5%)] would

represent a tax on the tax that was charged to the wholesaler by the manufacturer. If the 5 percent tax was also applied to the transfers to the retailer and to the ultimate consumer, there would be further applications of tax on previously assessed amounts of tax. Given this pyramiding problem, turnover taxes are not widely used.

## Value Added Tax (VAT)

### *Types*

21-29. VATs are multi-stage transaction taxes that can be assessed in two basic ways:

**Accounts-Based Method** In this approach, the tax is assessed on the basis of the value added at each level of the business process. It is usually based on some type of accounting based determination of income (e.g., value added).

**Invoice-Credit Method** In this approach, tax is assessed on gross sales. The taxpayer is then provided with a credit based on purchases made. No accounting based determination of income is required.

21-30. These two approaches will be illustrated in the material which follows.

### *Accounts-Based VAT*

21-31. Internationally, the most common type of VAT uses the accounts-based method. Using this method, transactions are taxed at each level in the distribution chain. Using whatever rate is established, the VAT is applied to the value added by the business to goods and services, rather than to the gross sales of the business.

21-32. If we assume a 5 percent rate of tax in the example presented in Figure 21-2, this method would require the raw materials supplier to charge tax on his sale price of $4 per unit. The manufacturer would then charge tax on the difference between the sales price of $10 per unit sold and the related input costs of $4 per unit sold. In corresponding fashion, the wholesaler would charge the 5 percent on the difference between the manufacturer's invoice of $10 per unit sold and the wholesale price of $25 per unit sold (i.e., the value added by the wholesaler). Finally, the retailer would charge the VAT on the difference between the retail price of $50 per unit sold and the wholesaler's price of $25 per unit sold. The total tax calculation is as follows:

| | |
|---|---|
| Raw Materials [(5%)(1,000)($4)] | $ 200 |
| Manufacturer To Wholesaler [(5%)(1,000)($10 - $4)] | 300 |
| Wholesaler To Retailer [(5%)(800)($25 - $10)] | 600 |
| Retailer To Consumer [(5%)(500)($50 - $25)] | 625 |
| Total Value Added Tax | $1,725 |

### *Invoice-Credit VAT*

21-33. This is the approach that is used in Canada for GST/HST calculations. Under this approach, each vendor charges tax on the full selling price. This tax is then offset by a credit for the tax that was paid on the costs incurred by the business (these are referred to as input tax credits).

21-34. Continuing to assume a 5 percent rate of tax is applied to our basic example from Figure 21-2, the invoice-credit VAT calculations would be as follows:

| | |
|---|---|
| **Raw Materials Supplier** | |
| GST Collected [(5%)(1,000)($4)] (No Input Tax Credits) | $200 |
| Net GST Payable | $200 |

| | |
|---|---|
| **Manufacturer** | |
| GST Collected [(5%)(1,000)($10)] | $500 |
| GST Paid On Costs = Input Tax Credits [(5%)(1,000)($4)] | ( 200) |
| Net GST Payable | $300 |

**Wholesaler**

| | |
|---|---|
| GST Collected [(5%)(800)($25)] | $1,000 |
| GST Paid On Costs = Input Tax Credits [(5%)(1,000)($10)] | ( 500) |
| Net GST Payable | $ 500 |

**Retailer**

| | |
|---|---|
| GST Collected [(5%)(500)($50)] | $1,250 |
| GST Paid On Costs = Input Tax Credits [(5%)(800)($25)] | ( 1,000) |
| Net GST Payable | $ 250 |

| | |
|---|---|
| Net Tax - Raw Materials Supplier | $ 200 |
| Net Tax - Manufacturer | 300 |
| Net Tax - Wholesaler | 500 |
| Net Tax - Retailer | 250 |
| Total Net Tax - All Levels | $1,250 |

## Comparison

21-35. The overall results for the two approaches is as follows:

| | |
|---|---|
| Total Tax - Accounts-Based VAT | $1,725 |
| Total Net Tax - Invoice-Credit VAT | ( 1,250) |
| Difference | $ 475 |

21-36. In this example, using the invoice-credit approach results in less tax being paid. The reason for this is that, when the invoice-credit approach is used, the enterprise receives tax credits for all purchases, without regard to whether or not the goods are sold. In this example, at both the wholesale and retail levels, purchases exceed sales. The tax credits are claimed from the government on units purchased, while the taxes collected are paid to the government on units sold. This means that enterprises benefit from having their purchases exceed their sales. In contrast, under an accounts-based VAT system, the tax to be paid is based on units sold and no benefit is received for taxes paid on units that are still on hand.

21-37. In general, if purchases and sales are equal, the tax that is assessed under an invoice-credit VAT system is similar to that assessed under an accounts-based VAT system. This can be seen at the manufacturer level in our example. In the case of the manufacturer, the units purchased and sold were equal. For this enterprise, the two VAT approaches resulted in exactly the same net tax ($300).

21-38. Given that the accounts-based VAT approach is more commonly used on a world-wide basis, there is some question as to why Canada chose to use the alternative invoice-credit approach. While background documents on the GST legislation do not provide a direct answer to this question, it would appear that the major advantage of the invoice-credit approach is that it does not rely on an accounting determination of value added. The tax is charged on all taxable goods sold, with input tax credits available for taxes paid on all expenditures for inputs used in commercial activities. The fact that there is no matching requirement avoids the controversies that can arise when various types of cost matching and allocation procedures are required.

21-39. It can also be argued that the invoice-credit approach is more equitable as it is more closely associated with actual cash flows than would be the case with an accounts-based system. The cash required to pay transaction taxes is based on purchases, without regard to when these inputs result in sales. As the invoice-credit approach provides for credits based on purchases, it can be argued that this approach is fairer to the enterprises that are involved in the production/distribution chain.

21-40. There is a further question of why the government chose to use a multi-stage tax, rather than implementing a less complex, single stage, federal sales tax at the retail level. An often cited reason is related to tighter administration and control. With the multi-stage approach, a vendor does not have to determine whether or not customers of particular goods and services are exempt because they are one or more steps away from the retail or final consumption level.

21-41. An additional reason for using a multi-stage tax is that it is applied further up the distribution chain. This, of course, means that the tax revenues accrue to the government at an earlier point in time.

**Exercise Twenty-One - 1**

**Subject:** Alternative VAT Approaches

During a taxation period, Darvin Wholesalers purchased merchandise for $233,000. Merchandise sales during this period totalled $416,000 and the cost of the merchandise sold was $264,000. Ignoring all other costs incurred by Darvin and assuming a rate of 5 percent, how much tax would be paid by Darvin under an account-based VAT system and, alternatively, under an invoice-credit VAT system?

**SOLUTION available in print and online Study Guide.**

**We suggest you work Self Study Problem Twenty-One-1 at this point.**

# Liability For GST/HST

## Basic Charging Provision

21-42. The basic charging provision for GST is found in the *Excise Tax Act* (ETA). It is as follows:

> **ETA 165(1) Imposition of goods and services tax —** Subject to this Part, every recipient of a taxable supply made in Canada shall pay to Her Majesty in right of Canada tax in respect of the supply calculated at the rate of 5% on the value of the consideration for the supply. [**Byrd/Chen Note** Additional legislation changes this rate to the appropriate rate in those provinces where the HST has been adopted.]

21-43. In order to understand this charging provision, it will be necessary to give attention to the concept of supply. We will cover this in the next section of this chapter.

21-44. Note that the tax is assessed on the recipient of, rather than the provider of, taxable supplies. As we shall find in a later section of this Chapter, responsibility for collection of the tax is with the provider of the taxable supplies (the GST registrant).

## The Concept Of Supply

21-45. The term "goods and services tax" implies that it is a tax that is applied to goods and services or, more specifically, transactions that involve the provision of goods and services. The term that is used by the *Excise Tax Act* in referring to such transactions is "supply". This term is defined in the *Act* as follows:

> **ETA 123(1) Supply** means the provision of property or a service in any manner, including sale, transfer, barter, exchange, licence, rental, lease, gift or disposition.

21-46. While this definition includes most of the items that we would consider to be revenues under GAAP, it is actually a much broader term. It would include all of the following:

- the sale, rental, or transfer of goods,
- the rendering of services,
- licensing arrangements for copyrights or patents,
- the lease, sale, or other transfer of real property, and
- barter transactions or gifts.

# Supply Categories

**NOTE ON GST/HST DIFFERENCES** While the HST provinces use the same categories of supply that are used in the federal GST legislation, some fully taxable items are given point-of-sale rebates for the provincial component of the HST (e.g., Ontario provides an 8 percent point-of-sale HST rebate for children's clothing). In effect, purchasers pay only the federal GST rate of 5 percent on these items.

A full description of these differences for all of the HST provinces goes beyond the scope of this text. Given this, the examples that are described in the following discussion include items that fall into the fully taxable category under the federal GST legislation. Because of provincial rebates in the HST provinces, purchasers of some of these items will not pay the full HST rate.

## Taxable Supplies

### General Rules

21-47. The *Excise Tax Act* defines taxable supplies as follows:

**ETA 123(1) Taxable supply** means a supply that is made in the course of a commercial activity.

21-48. Expanding on this definition, commercial activity is defined in the *Excise Tax Act* as follows:

**ETA 123(1) Commercial Activity** of a person means

(a) a business carried on by the person (other than a business carried on without a reasonable expectation of profit by an individual, a personal trust or a partnership, all of the members of which are individuals), except to the extent to which the business involves the making of exempt supplies by the person,

(b) an adventure or concern of the person in the nature of trade (other than an adventure or concern engaged in without a reasonable expectation of profit by an individual, a personal trust or a partnership, all of the members of which are individuals), except to the extent to which the adventure or concern involves the making of exempt supplies by the person, [**Byrd/Chen Note** In somewhat simplified terms, an adventure or concern in the nature of trade is a one-shot business venture, as opposed to an ongoing activity.] and

(c) the making of a supply (other than an exempt supply) by the person of real property of the person, including anything done by the person in the course of or in connection with the making of the supply.

21-49. As used here, the term business has the following meaning:

**ETA 123(1) Business** includes a profession, calling, trade, manufacture or undertaking of any kind whatever, whether the activity or undertaking is engaged in for profit, and any activity engaged in on a regular or continuous basis that involves the supply of property by way of lease, licence or similar arrangement, but does not include an office or employment;

21-50. Stated in practical, every-day language, this says that if you are providing goods or services in the course of business activity, or if you selling or leasing real property, you are providing taxable supplies unless:

- the business does not have a reasonable expectation of profit (this criterion only applies to businesses run by individuals, certain partnerships, or certain trusts);
- the supplies are exempt supplies; or
- the services are employment services.

21-51. Taxable supplies fall into two categories. The first category is supplies that we will refer to as fully taxable supplies. The second category is supplies that are zero-rated.

### Fully Taxable Supplies

21-52. Fully taxable supplies are those that are taxed at the 5 percent federal GST rate or the appropriate HST rate (13 or 15 percent). Examples of fully taxable supplies include:

- transportation in Canada,
- restaurant meals and beverages,
- clothing and footwear,
- furniture,
- admissions to concerts, athletic and other events
- contractors' services,
- legal and accounting fees,
- haircuts, and
- cleaning services.

### Zero-Rated Supplies

21-53. The *Excise Tax Act* provides a list of taxable supplies that are designated as zero-rated. While these supplies are said to be taxable, they are taxed at zero percent, rather than the regular GST or HST rate.

21-54. At first glance, this concept seems a bit senseless in that there is no tax charged on either zero-rated supplies or exempt supplies. However, an important difference exists. Because zero-rated supplies are considered to be taxable supplies, the providers of such supplies can recover the GST/HST paid on business purchases as input tax credits. In contrast, providers of exempt supplies are not eligible for input tax credits (see Paragraph 21-103).

21-55. In addition, as zero-rated supplies are considered taxable at a rate of zero percent, they are included in the threshold amounts for determining the filing frequency of a registrant's GST or HST returns. This is covered beginning in Paragraph 21-134.

21-56. Common items included in the category of zero-rated supplies are as follows:

- prescription drugs,
- medical devices such as wheelchairs, eye glasses, canes, hospital beds, and artificial limbs,
- basic groceries,
- most agricultural and fishing products,
- goods and services exported from Canada, and
- foreign travel and transportation services (see following Paragraph).

21-57. Some elaboration is required for the meaning of foreign travel. Surface travel by ship, bus, or train is zero-rated when the origin or termination point is outside Canada (e.g., a train trip to the U.S. is zero-rated). Domestic surface travel is fully taxable.

21-58. In the case of air travel, the GST/HST rules can be complicated. International air travel is zero-rated only when flights are deemed to be outside of continental North America, not just outside of Canada. As an example of the possible complications, this broader definition can make Canadian air travel to and from the United States fully taxable.

## Exempt Supplies

21-59. As was the case with zero-rated supplies, the *Excise Tax Act* provides a list of supplies that are exempt from GST. Persons providing exempt supplies do not collect GST/HST and are not eligible for input tax credits for GST/HST paid on the related purchases. As we shall see when we discuss input tax credits, this means that suppliers of exempt supplies pay GST/HST

that is not refundable to them on the fully taxable goods and services required to operate their business. As a consequence, the non-recoverable GST/HST paid is a cost of doing business that is likely to be passed on to customers in the form of higher prices.

21-60. Some common items that are included in the category of exempt supplies are as follows:

- basic health care and dental services (which does not include cosmetic surgery),
- financial services provided to Canadian residents,
- sales of used residential housing and long-term residential rents (e.g., rentals for more than 30 days),
- most land sold by individuals where the land was not used in a business,
- educational courses leading to certificates or diplomas, tutoring for credit courses, and music lessons,
- child or personal care services, and
- a wide variety of services provided by charities, not-for-profit, and government organizations (see discussion under Specific Applications at Paragraph 21-188).

# Applying the GST/HST Rate

## Place Of Supply

### *The Problem*

21-61. The rate at which GST or HST will be applied varies from a low of 5 percent in a province where only the GST is applicable (e.g., Alberta), to a high of 15 percent under the HST regime (e.g., Nova Scotia). The size of this range makes the question of which rate should be applied to a particular supply of goods and services a significant issue.

21-62. A further question relates to whether the tax should be assessed on the basis of the location of the registrant providing the supply or, alternatively, the location of the recipient of the supply. Prior to 2010, the place of supply rules were mostly based on the location of the supplier. The current rules rely more heavily on where the recipient is located. This means that a supplier must be able to deal with the transaction taxes in any province his goods and services are delivered to, as well as the transaction taxes in the province where he is located.

21-63. There are, of course, many complications in the application of these rules. What follows provides only a basic overview of how these rules work.

### *Tangible Goods*

21-64. The rules for tangible goods are relatively straightforward. A GST registrant will calculate taxes on the basis of the rules that are in effect in the province where the goods are delivered. The following example illustrates the application of this approach.

> **EXAMPLE** An Ontario HST registrant sells shirts online and ships them to purchasers in Ontario, Prince Edward Island, Alberta and Quebec.
>
> **ANALYSIS** The GST/HST rate charged on the sales will vary as follows:
>
> - Ontario recipient - HST will be charged at 13 percent.
> - Prince Edward Island recipient - HST will be charged at 15 percent.
> - Alberta recipient - only GST at 5 percent will be charged.
> - Quebec recipient - only GST at 5 percent will be charged. This example makes the point that Quebec is using a separate transaction tax (QST), rather than harmonizing with the federal GST. If the Ontario registrant was a QST registrant as well, QST would also be charged on this sale. Note that Quebec consumers are required to voluntarily pay the relevant QST to Revenu Quebec on purchases shipped from outside Quebec that do not have QST charged. It is likely that this liability frequently remains unpaid as many Quebec consumers are either unaware of this requirement or, alternatively, deliberately choose to ignore it.

### Real Property

21-65. As real property cannot be moved across provincial boundaries, there are few complications in this area. The GST or HST will be assessed on the basis of the rules in effect in the province where the real property is located. For example, on a taxable sale of real property in Ontario, HST is applicable at 13 percent regardless of where the vendor resides.

### Services

21-66. This area has the most complications in terms of the place of supply rules. The basic idea is that the place of supply is the province where the services are used.

> **EXAMPLE** A professor at a Manitoba university is also a freelance editor of a widely used accounting text. He does his editing in his office in Winnipeg. His editing fees are consistently in excess of $50,000 per year. Because of this, he is a GST registrant (Manitoba does not participate in the HST program). His work is sent to the Toronto office of the publisher and cheques for his fees are issued from that office.
>
> **ANALYSIS** As the services are "used" in Ontario, the editor would bill HST at 13 percent.

## Applying The Rate

### Consideration Received

21-67. To determine the amount of GST or HST to be charged, the appropriate rate is applied to the amount of consideration received in return for the delivery of taxable supplies. In most cases, the consideration will be monetary and the amount to be recorded is obvious. If the consideration is non-monetary (e.g., a barter transaction), GST/HST is still applicable. In this case, however, an estimate will have to be made of the fair market value of the consideration received.

21-68. The amount of consideration to be used for purposes of calculating the GST/HST includes all non-refundable federal taxes, provincial taxes other than retail sales taxes, and duties and fees that are imposed on either the supplier or recipient in respect of the property or services supplied.

### Effect Of Trade-Ins

21-69. Where a good owned by an entity that is not registered for GST/HST is traded in towards the supply of a new good, GST/HST is only required to be levied on the net amount after the trade-in. These types of transactions are most often seen in the automotive business, where used cars are traded in when purchasing a newer automobile.

> **EXAMPLE** John Bailey, a resident of Alberta, is acquiring a new Volvo at a cost of $52,000. He is given a trade-in allowance of $21,000 on his old vehicle.
>
> **ANALYSIS** The applicable GST would be $1,550 [(5%)($52,000 - $21,000)].

# Collection And Remittance Of GST/HST

21-70. As you are aware, income taxes are collected from the same person on whom the tax is assessed. An individual will calculate his Tax Payable by applying the appropriate rates to his Taxable Income. This same individual is also responsible for the payment of this tax.

21-71. The situation is different with GST/HST. We noted previously that the basic GST/HST charging provision assesses the tax on the recipient of the taxable supply. However, the basic responsibility for the collection and remittance of the GST/HST falls on the provider of the taxable supply. This approach is implemented by requiring providers of taxable supplies to become GST registrants. Registration requirements are discussed in the section which follows.

21-72. As an example of this process, consider a situation where a retailer is featuring a GST holiday.

**EXAMPLE** An Alberta store advertises a GST holiday, indicating that merchandise can be purchased without paying the GST. A customer pays the marked price of $2,500 for a new freezer and no additional amount is added for GST.

**ANALYSIS** From the customer's point of view, he has not paid the GST. However, the store will have to treat the $2,500 as a GST inclusive amount. For GST purposes, the $2,500 received was made up of $2,380.95 ($2,500 ÷ 105%) for the freezer and GST of $119.05 [(5%)($2,380.95)]. The store must include the GST received of $119.05 in its GST return.

21-73. You should note that, while the vendor is responsible for the collection of GST/HST, this does not relieve the purchaser of the responsibility for payment. If a vendor fails to collect the tax, the CRA can assess the purchaser for the unremitted amount. This, however, would be a fairly rare procedure.

# Registration

## Meaning Of Person For GST/HST

21-74. For GST/HST purposes, the *Excise Tax Act* defines a person as follows:

**ETA 123(1) Person** means an individual, a partnership, a corporation, the estate of a deceased individual, a trust, or a body that is a society, union, club, association, commission or other organization of any kind.

21-75. Note that this definition is broader than the one that is included in the *Income Tax Act*. For income tax purposes, the term "person" includes only individuals, corporations, and trusts. Of importance here is the fact that the GST definition includes unincorporated businesses, partnerships, and not-for profit organizations.

## Who Must Register

### *Basic Requirement*

21-76. As we have previously indicated, the collection of GST/HST is administered through a registration requirement for providers of taxable supplies. This requirement is as follows:

**ETA 240(1)** Every person who makes a taxable supply in Canada in the course of a commercial activity engaged in by the person in Canada is required to be registered for the purposes of this Part, except where

(a) the person is a small supplier;
(b) the only commercial activity of the person is the making of supplies of real property by way of sale otherwise than in the course of a business; or
(c) the person is a non-resident person who does not carry on any business in Canada.

21-77. This requirement contains several terms and concepts that require further elaboration. We will deal with these items in the section which follows.

### *Commercial Activity - Inclusions*

21-78. ETA 240(1) requires registration only when "taxable supplies" are delivered in the course of "commercial activity". We have previously covered both of these definitions in our discussion of taxable supplies beginning in Paragraph 21-47.

21-79. In simple terms, any person who provides non-exempt goods or services, in the course of a business activity, is required to register for the GST/HST unless that person is covered by one of the exceptions listed in ETA 240(1).

### *Commercial Activity - Exclusions*

21-80. There are several activities that might be considered commercial activity in a non-GST context that are excluded in the preceding definitions. For example, the following are not considered commercial activities for GST purposes:

- business activity that is carried on by an individual without a reasonable expectation of profit
- the provision of exempt supplies (e.g., child care services)
- the provision of employment services

21-81. Registration for GST/HST is not required or permitted if a person is involved solely in an excluded activity.

## Exemption For Non-Residents

21-82. The ETA 240(1) requirement to register, in general excludes non-residents. The major exception to this would be when a non-resident person carries on business in Canada. This exception would apply, without regard to whether the business is carried on through a permanent establishment. An additional exception could arise in situations where a non-resident has registered for GST/HST on a voluntary basis.

21-83. In general, resident is defined for GST/HST purposes in the same manner that it is defined for income tax purposes. We would refer you to Chapter 1 for a discussion of the issues associated with residence determination.

## Exemption For Small Suppliers

### *Last Four Calendar Quarters Test (Cumulative)*

21-84. The ETA 240(1) registration requirement indicates that it is not applicable to "small suppliers". The idea here is that a small supplier is a person whose delivery of taxable supplies, including those of associated businesses, is less than $30,000 per year. This provision is intended to provide compliance relief for the operators of very small businesses.

21-85. The basic test for qualification as a small supplier is based on calendar year quarters (i.e., January to March, April to June, July to September, and October to December). Under this test, an entity qualifies as a small supplier in the current quarter and the month following the current quarter if the entity and its associated entities did not have cumulative taxable supplies exceeding $30,000 during the four calendar quarters preceding the current quarter.

21-86. If taxable supplies accumulate to $30,000 in any period consisting of two to four quarters (they do not have to be in the same calendar year), the entity ceases to be a small supplier at the end of the month following the quarter in which the $30,000 limit was exceeded. The deemed date of registration would be the day the first supply (sale) was made after ceasing to be a small supplier. The supplier must formally register within 29 days from the deemed registration day.

**EXAMPLE** Supplier A opened for business on January 1, 2019, and earned the following revenues from taxable supplies during the year:

| Quarter | Months | Taxable Supplies |
|---|---|---|
| One | January to March | $ 7,000 |
| Two | April to June | 8,000 |
| Three | July to September | 20,000 |
| Four | October to December | 9,000 |
| Total | | $44,000 |

**ANALYSIS** Supplier A's revenues accumulate to more than $30,000 in the third quarter of 2019 ($7,000 + $8,000 + $20,000 = $35,000). This means that Supplier A is required to collect GST/HST starting on November 1, 2019, which is one month after the end of the July to September quarter. The deemed registration day is the day of the first sale on or after November 1, 2019. Formal registration is required within 29 days of the deemed registration day.

### Calendar Quarter Test (> $30,000 In Single Quarter)

21-87. An alternative to the "last four calendar quarters" test is the “calendar quarter test”, where the $30,000 threshold is exceeded in a single calendar quarter. When a sale results in the $30,000 threshold being exceeded in a single quarter, the person is immediately deemed a registrant and must collect GST/HST on the supply (sale) that caused the limit to be exceeded, even though they are not yet registered. The supplier must formally register within 29 days from the deemed registration day.

**EXAMPLE** Supplier B started in business on January 1, 2019. The business is an art gallery and Supplier B had only two sales in 2019, one for $39,000 on May 15 and the other for $5,000 on August 28.

| Quarter | Months | Taxable Supplies |
|---|---|---|
| One | January to March | Nil |
| Two | April to June (May 15) | $39,000 |
| Three | July to September (August 28) | 5,000 |
| Four | October to December | Nil |
| Total | | $44,000 |

**ANALYSIS** Supplier B would be deemed a registrant as of the May 15 sale, reflecting the fact that this single sale pushes the sales for that quarter past the $30,000 threshold amount. Starting with that sale, GST/HST should be collected on all taxable supplies made. While Supplier B does not have to register until 29 days after the May 15th sale, the collection of GST/HST is required starting with that sale.

21-88. In reviewing the two preceding examples, note that Supplier A and Supplier B each earned taxable revenue of $44,000 in the four calendar quarters for 2019. Supplier B, however, exceeded the $30,000 threshold in Quarter Two. This results in Supplier B being deemed to be registered starting with the May 15 transaction. In contrast, Supplier A will not have to start collecting GST/HST until November 1, 2019 using the last four calendar quarters test.

## Exercise Twenty-One - 2

**Subject:** Requirement To Register

Ms. Sharon Salome and Mr. Rock Laughton begin separate businesses on April 1, 2019. The quarterly sales of taxable items for both businesses are as follows:

| Calendar Quarter | Sharon Salome | Rock Laughton |
|---|---|---|
| April To June, 2019 | $10,000 | $ 8,000 |
| July To September, 2019 | 4,000 | 13,000 |
| October To December, 2019 | 35,000 | 4,000 |
| January To March, 2020 | 40,000 | 17,000 |

At what point in time will Ms. Salome and Mr. Laughton have to begin collecting GST? At what point will they be required to register?

**SOLUTION available in print and online Study Guide.**

### Voluntary Registration

21-89. The small supplier exemption can represent an advantage to persons with limited commercial activity whose clients are consumers who cannot claim input tax credits. If the vendor is not registered, the goods or services can legally be sold without charging GST/HST which would result in savings for consumers that could be substantial.

21-90. There is, however, a disadvantage to this exemption. If a person does not register, they cannot receive input tax credits for GST/HST paid. They are effectively treated as the final consumer. This means that the business must either absorb the GST/HST paid on its costs or, alternatively, pass the GST/HST paid on purchases and expenses on to its customers in the form of higher prices.

21-91. Given this problem, voluntary registration is an alternative. Any person engaged in commercial activity in Canada can apply to be registered, even if taxable sales are less than the $30,000 small supplier threshold. In making a decision as to whether to use this option, the person must consider the value of the input tax credits that will be available. However, the person must also consider whether charging GST/HST will reduce the demand for his product or service, especially if some of the competition doesn't charge GST/HST.

### *Registrants Ineligible For The Small Supplier Exemption*

21-92. ETA 240 contains two other subsections which effectively prohibit the use of the small supplier exemption for certain types of suppliers. ETA 240(1.1) indicates that suppliers of taxi services must register, even if their revenues are less than $30,000 per year. By deeming the provision of commercial ride-sharing services (e.g., Uber) a taxi business, all of those drivers are required to register as well. ETA 240(2) requires registration of any non-resident who enters Canada for the purpose of making taxable supplies of admissions in respect of a place of amusement, a seminar, an activity or an event.

**We suggest you work Self Study Problem Twenty-One-2 at this point.**

# Input Tax Credits

## Vendors Of Fully Taxable And Zero-Rated Supplies

### *General Rules*

21-93. A GST registrant must collect and remit GST/HST on sales of fully taxable supplies. In the process of supplying these goods and services, the registrant will incur costs, some of which are likely to include GST/HST. To the extent that these costs have been incurred in commercial activity (i.e., supplying either fully taxable or zero-rated goods and services), the registrant can claim a refund of the GST/HST that has been included in these costs.

21-94. The refunds that are available to the registrant are referred to as input tax credits. As was the case with some credits against income tax payable, input tax credits can be thought of as refundable. That is, if the available input tax credits for the period exceed the GST/HST collections for the period, the registrant can claim a GST/HST refund.

21-95. As will be discussed in the sections which follow, the rules for claiming input tax credits vary, depending on whether the GST/HST was paid on current expenditures (e.g., purchases of merchandise inventories) or, alternatively, capital expenditures (e.g., buildings or equipment). In addition, the rules also vary with the type of capital expenditure on which the GST/HST was paid.

21-96. It is important to note that, in claiming input tax credits there is no matching of costs and revenues. Input tax credits on inventory purchases become available at the time of purchase, not when the goods are sold and charged to income for accounting purposes. Input tax credits on capital expenditures become available when the asset is acquired, not over the useful life of the asset.

### *Current Expenditures*

21-97. With respect to current expenditures, if all, or substantially all (generally understood in tax work to mean 90 percent or more), of a current expenditure is related to commercial activity, then all of the GST/HST that was paid can be claimed as an input tax credit. In contrast, if 10 percent or less of an expenditure is related to commercial activity, no input tax credit can be claimed. If the percentage of the current expenditure used for commercial activity is between 10 and 90 percent, the input tax credit available is calculated by multiplying the total GST/HST paid by the percentage of commercial activity usage.

## Capital Expenditures

21-98. In line with the basic idea that input tax credits are not matched against amounts of GST/HST collected on sales, the GST/HST paid on purchases of capital assets used in commercial activities is eligible for treatment as an input tax credit at the time of purchase, regardless of when the purchases are paid for, or how they are amortized.

21-99. In general, capital property for GST/HST purposes has the same meaning that is used for income tax purposes. However, for GST/HST purposes it can either be capital real property or capital personal property. In situations where a capital asset is used only partially for commercial activity, the approach used to calculate the available input tax credits will depend on the type of capital asset involved:

> **Capital Real Property (Land And Buildings)** For this type of property, the input tax credit available is in proportion to the extent to which the property is used in commercial activities. That is, if the building is used 35 percent for commercial activities, the input tax credit will be equal to 35 percent of the GST/HST paid on its acquisition. In other words, input tax credits on real property are available on a pro rata basis, with the available portion based on usage in commercial activities.
>
> As is the case with current expenditures, if commercial usage is 10 percent or less, the purchaser cannot claim any input tax credit. Alternatively, if the usage is 90 percent or more, 100 percent of the GST/HST paid can be claimed as an input tax credit.
>
> **Capital Personal Property (Capital Property Other Than Real Property)** In order for the input tax credits to be available on capital personal property, the assets must be used "primarily" in commercial activities. In tax work, "primarily" is generally understood to be more than 50 percent. If commercial usage is 50 percent or less, none of the GST/HST paid on the capital personal property's acquisition can be claimed as an input tax credit. If commercial usage is more than 50 percent, the registrant is eligible for an input tax credit equal to 100 percent of the GST/HST paid.

## Restrictions On Claiming Input Tax Credits

21-100. As noted in previous Chapters of this text, income tax legislation restricts the deductibility of certain types of business costs. For many of these items, there is a corresponding restriction on the ability of the business to claim input tax credits for GST/HST purposes. Some of the more common restrictions are as follows:

> **Passenger Vehicles** No input tax credits are available for GST/HST paid on the portion of the cost or lease payment of a passenger vehicle that is in excess of the deduction limits. For 2019, these limits are $30,000 cost and $800 monthly lease payments, excluding GST/HST and PST. Also, if the vehicle is owned by a registrant who is an individual or a partnership and the vehicle is used partly for business (less than 90 percent) and partly for personal use, the input tax credit is prorated based on the annual CCA claimed.
>
> **Club Memberships** No input tax credit is allowed for GST/HST paid on membership fees or dues in any club whose main purpose is to provide dining, recreational, or sporting facilities.
>
> **Provision Of Recreational Facilities** No input tax credits are available for the GST/HST costs of providing certain types of recreational facilities to employees, owners, or related parties.
>
> **Business Meals And Entertainment** The recovery of GST/HST on deductible meals and entertainment expenses is limited to 50 percent of the amounts paid.
>
> **Personal Or Living Expenses** Input tax credits cannot be claimed on costs associated with the personal or living expenses of any employee, owner, or related individual. An exception is available when GST/HST is collected on the provision of the item to the employee, owner, or related individual.

**Figure 21 - 3**
**Maximum Input Tax Credits**

| Taxable Purchase | Percentage Used In Commercial Activities = X% | Input Tax Credit |
|---|---|---|
| Current Expenditures* | X% ≤ 10% | Nil |
| and Capital Real Property | 10% < X% < 90% | X% |
| | X% ≥ 90% | 100% |
| Capital Personal Property | X% ≤ 50% | Nil |
| (Excluding Passenger Vehicles*) | X% > 50% | 100% |

*Special rules apply to certain items. See Paragraph 21-100.

**Reasonableness** Both the nature and value of a purchase must be reasonable in relation to the commercial activities of the registrant before an input tax credit can be claimed. This is similar to the reasonableness test that is found in the *Income Tax Act*.

21-101. Restrictions also apply to the time allowed for claiming input tax credits. For large businesses, whose sales are less than 90 percent taxable but in excess of $6 million, and listed financial institutions, the time limit is generally 2 years from the date the input tax credit was first available. For all other registrants the time limit is 4 years.

### Summary Of Rules

21-102. The rules for apportioning the maximum available input tax credits on purchases are summarized in Figure 21-3.

## Vendors Of Exempt Supplies

21-103. Vendors of exempt supplies cannot claim any GST/HST paid on purchases that relate to exempt supplies. In some situations, vendors are involved in making fully taxable or zero-rated supplies, as well as exempt supplies. Since these businesses can only recover GST/HST paid on their fully taxable or zero-rated activities, they must apportion their input tax credits on a "reasonable" basis. This applies to both current and capital expenditures that cannot be directly identified with particular exempt or taxable activities.

## Accounting vs. Income Tax vs. GST/HST

### Differences

21-104. The concept of matching is integral to the determination of business income for both accounting and income tax purposes. For GST/HST purposes, the matching concept is not relevant. GST/HST is collected when taxable supplies are provided and input tax credits are refunded when the inputs for taxable supplies are purchased. No attempt is made to match the input tax credits claimed with sales of the related taxable supplies.

21-105. Other significant differences between accounting, income tax and GST/HST procedures are as follows:

- Most accounting and income tax allocations, for example amortization or CCA, are irrelevant for GST/HST purposes. GST/HST paid on capital expenditures that are eligible for input tax credits can generally be claimed in the period in which the expenditure is made. (Differences between accounting income and income for tax purposes were discussed in Chapter 6 and would also be applicable here.)
- Many deductible expenses for income tax purposes do not affect the GST/HST payable or receivable. For example, GST/HST does not apply to employee wages, interest, property taxes, and educational services. While such costs are usually fully deductible in the calculation of Net Income For Tax Purposes, they do not require the payment of GST/HST and, as a consequence, do not generate input tax credits.

### Similarities

21-106. In contrast to these differences, there are some features that are common to GST/HST and income tax calculations. For example, GST/HST is normally collected and revenue is recognized for income tax purposes when an invoice is issued for the provision of goods or services. When the invoice is paid is not a relevant consideration for either income tax or GST/HST purposes.

21-107. Similarly, if an account receivable becomes uncollectible, an adjustment is required for both income tax and GST/HST purposes. Also, as we have noted, some of the restrictions that apply in the deductibility of certain expenses for income tax purposes (e.g., 50 percent of business meals and entertainment and certain costs of owning or leasing automobiles) are also contained in the GST/HST legislation.

### Financial Statement Presentation

21-108. This issue is covered in IAS No. 18, *Revenue*. This international accounting standard indicates that taxes that are to be refunded should not be included in reported revenues. There is no corresponding statement with respect to expenses. However, it would be logical to assume that any GST/HST paid that is eligible for an input tax credit would not be included in the reported expense. Note, however, that even though the revenues and expenses are reported net of GST/HST, the amounts due to and recoverable from the government must be included in the receivables and payables of the enterprise.

## Example One - Fully Taxable And Zero-Rated Supplies

21-109. In this example, we will assume that the company sells only fully taxable and zero-rated supplies.

**EXAMPLE** Marson Ltd. is located in the province of Alberta which does not have a provincial sales tax and does not participate in the HST system. In the following Income Statement of Marson Ltd. for the year ending December 31, 2019, all of the items are recorded net of any GST collected or paid.

| | |
|---|---|
| Sales | $9,500,000 |
| Expenses: | |
| Cost Of Goods Sold | ($6,500,000) |
| Amortization Expense | ( 900,000) |
| Salaries And Wages | ( 1,500,000) |
| Other Expenses | ( 200,000) |
| Total Expenses Excluding GST And Income Taxes | ($9,100,000) |
| Net Income Before GST And Income Taxes | $ 400,000 |

**Other Information:**

1. Of the total Sales, $6,800,000 were fully taxable supplies. The remaining $2,700,000 ($9,500,000 - $6,800,000) were zero-rated.
2. Purchases of merchandise exceeded the Cost Of Goods Sold by $2,200,000, net of GST. All of the merchandise sold and purchased involved fully taxable supplies.
3. Of the Other Expenses, 80 percent related to fully taxable supplies, while the remaining 20 percent related to zero-rated supplies.
4. During 2019, capital expenditures totaled $7,500,000, net of GST, and the amounts have not been paid. These consisted of $5,000,000 for an office building and $2,500,000 for furniture and fixtures. The office building was used 60 percent for fully taxable supplies and 40 percent for zero-rated supplies. The furniture and fixtures were used 55 percent for fully taxable supplies and 45 percent for zero-rated supplies.

**ANALYSIS** Based on this information Marson Ltd. is eligible for a GST refund calculated as follows:

| | |
|---|---|
| GST Collected [(5%)($6,800,000)] | $340,000 |
| Input Tax Credits: | |
| Purchases [(5%)($6,500,000 + $2,200,000)] | ( 435,000) |
| Amortization Expense | Nil |
| Salaries And Wages | Nil |
| Other Expenses [(5%)(80% + 20%)($200,000)] | ( 10,000) |
| Building [(5%)(60% + 40%)($5,000,000)] | ( 250,000) |
| Furniture And Fixtures [(5%)(55% + 45%)($2,500,000)] | ( 125,000) |
| GST Payable (Refund) - With Zero-Rated Supplies | ($480,000) |

21-110. You will note that, while Marson Ltd. is showing a positive Net Income for accounting purposes, the Company is eligible for a GST refund. This example clearly illustrates the fact that GST reporting is not based on the matching principle. The input tax credits are available on the entire amount of capital expenditures, without regard to whether they have been paid for or amortized for accounting purposes. In addition, input tax credits are available on all of the inventory purchases, without regard to whether the merchandise has been sold.

## Example Two - Fully Taxable And GST Exempt Supplies

21-111. In this example, we have revised the Marson Ltd. example so that the Company sells fully taxable and GST exempt supplies. The revised information is repeated here for your convenience.

**EXAMPLE** Marson Ltd. is located in the province of Alberta which does not have a provincial sales tax and does not participate in the HST system. In the following Income Statement of Marson Ltd. for the year ending December 31, 2019, all of the items are recorded net of any GST collected or paid.

| | |
|---|---|
| Sales | $9,500,000 |
| Expenses: | |
| Cost Of Goods Sold | ($6,500,000) |
| Amortization Expense | ( 900,000) |
| Salaries And Wages | ( 1,500,000) |
| Other Expenses | ( 200,000) |
| Total Expenses Excluding GST And Income Taxes | ($9,100,000) |
| Net Income Before GST And Income Taxes | $ 400,000 |

**Other Information:**

1. Of the total Sales, $6,800,000 were fully taxable supplies. The remaining $2,700,000 ($9,500,000 - $6,800,000) were GST exempt supplies.
2. Purchases of merchandise exceeded the Cost Of Goods Sold by $2,200,000, net of GST. All of the merchandise sold and purchased involved fully taxable supplies.
3. Of the Other Expenses, 80 percent related to fully taxable supplies, while the remaining 20 percent related to GST exempt supplies.
4. During 2019, capital expenditures totaled $7,500,000, net of GST, and the amounts have not been paid. These consisted of $5,000,000 for an office building and $2,500,000 for furniture and fixtures. The office building was used 60 percent for fully taxable supplies and 40 percent for GST exempt supplies. The furniture and fixtures were used 55 percent for fully taxable supplies and 45 percent for GST exempt supplies.

**ANALYSIS** Based on this revised information, the GST refund for Marson Ltd. would be calculated as follows:

| | |
|---|---|
| GST Collected [(5%)($6,800,000)] | $340,000 |
| Input Tax Credits: | |
| Purchases [(5%)($6,500,000 + $2,200,000)] | ( 435,000) |
| Amortization Expense | Nil |
| Salaries And Wages | Nil |
| Other Expenses [(5%)(80% + 0%)($200,000)] | ( 8,000) |
| Building [(5%)(60% + 0%)($5,000,000)] | ( 150,000) |
| Furniture And Fixtures [(5%)(100%)($2,500,000)] | ( 125,000) |
| GST Payable (Refund) - With GST Exempt Supplies | ($378,000) |

21-112. In this example, where some of the costs relate to the provision of exempt supplies, only 80 percent of the GST on Other Expenses is eligible for an input tax credit. Similarly, only 60 percent of the GST paid on the Building is eligible. However, because the Furniture And Fixtures were capital personal property and used primarily (more than 50 percent) for commercial activity, the full amount of the GST paid is eligible for an input tax credit, even though 45 percent of their usage was for the provision of GST exempt supplies.

## Exercise Twenty-One - 3

**Subject:** HST Calculation

All of the operations of March Ltd. are located in Ontario where the relevant HST rate is 13 percent. During the current quarter, March Ltd. has taxable sales of $1,223,000 before HST. Its cost of sales for the period was $843,000 before HST and its merchandise inventories increased by $126,000, again before HST. Salaries and wages for the period totalled $87,000, interest expense was $16,000, and amortization expense was $93,000. No capital expenditures were made during the period.

Determine the net HST payable or refund for the quarter.

## Exercise Twenty-One - 4

**Subject:** HST Calculation

Ms. Marsha Stone lives and works in Nova Scotia where the relevant HST rate is 15 percent. During the current year, she records headhunting service revenue of $224,000.

Rent for this period on her office premises totals $25,800 and she pays a clerical assistant an annual salary of $18,500. Her capital expenditures during the period are for new office furniture with a cost of $36,000 and computer hardware and software for $20,000. All amounts are before the addition of HST and the assets are used 100 percent for the provision of taxable supplies. She files her HST return on an annual basis.

Determine the net HST payable or refund for the year.

**SOLUTIONS available in print and online Study Guide.**

## Exercise Twenty-One - 5

**Subject:** Input Tax Credits On Capital Expenditures

Modam Ltd. is located in Alberta, a province which does not participate in the HST program and has no provincial sales tax. All of its operations are in that province. During its current quarter, Modam Ltd. purchases an office building and land for a total of $1,200,000 before GST. The Company spends an additional $226,000 (before GST) on office equipment. The building will be used 40 percent for taxable supplies and 60 percent for exempt supplies. The office equipment is to be allocated in the same ratio. For accounting purposes, the building will be amortized over 40 years, while the office equipment will be written off over 4 years. Determine the input tax credits that Modam Ltd. can claim as a result of these capital expenditures.

**SOLUTION available in print and online Study Guide.**

**We suggest you work Self Study Problems Twenty-One-3 and 4 at this point.**

# Relief For Small Businesses

## Quick Method Of Accounting

### *General Rules*

21-113. Eligible businesses, defined as businesses with annual GST/HST included taxable sales, including those of associated businesses, of $400,000 or less during the year, can elect to use the Quick Method of determining the net GST/HST remittance. Both fully taxable and zero-rated supplies are included in calculating the $400,000 threshold, while exempt supplies, supplies made outside of Canada, sales of capital real and personal property, and provincial sales taxes are excluded. In addition, businesses involved in legal, accounting and financial consulting services are not eligible for the Quick Method.

21-114. If the Quick Method election is filed, the registrant charges GST or HST at the normal rate on taxable sales. The major advantage of this method is that the business is not required to keep detailed records of current expenditures that are eligible for input tax credits. Note, however, that when this method is used for current expenditures, the registrant can still claim input tax credits on capital expenditures. This means that there will continue to be a need to track the input tax credits on specific capital expenditures.

21-115. In the absence of detailed records on current expenditures eligible for input tax credits, a specified percentage, the remittance rate, is applied to the GST/HST inclusive total of fully taxable sales to determine the amount of GST/HST to be remitted.

21-116. Note that the remittance rate is not an alternative GST/HST rate. It is based on an assumed relationship between revenues subject to GST/HST and costs on which input tax credits are available. For example, the Quick Method remittance rate for service providers in Alberta is 3.6 percent. The following example illustrates (without going into the algebra that is involved) that this rate is based on the assumption that, for service providers subject only to GST, eligible costs are equal to 24.4 percent of fully taxable sales.

**EXAMPLE** An Alberta GST registrant who is providing fully taxable services has taxable revenues of $50,000 in its second, third and fourth quarters. Its eligible current expenditures for these quarters are $5,000 (less than 24.4% of revenues) for quarter 2, $12,200 (equal to 24.4% of revenues) for quarter 3, and $30,000 (more than 24.4% of revenues) for quarter 4.

**ANALYSIS** The GST Payable calculated under the Quick Method is $1,890 [(3.6%)(105%)($50,000)]. The Quick Method results are the same for each quarter as the calculation is based on revenues and is not affected by the amount of current expenditures. GST Payable under the regular and Quick Method would be as follows:

| | Quarter 2 | Quarter 3 | Quarter 4 |
|---|---|---|---|
| GST On Revenues [(5%)($50,000)] | $2,500 | $2,500 | $2,500 |
| Input Tax Credits On Costs At 5% | ( 250) | ( 610) | ( 1,500) |
| GST Payable - Regular Method | $2,250 | $1,890 | $1,000 |
| GST Payable - Quick Method (Note) | ( 1,890) | ( 1,890) | ( 1,890) |
| Advantage (Disadvantage) Quick Method | $ 360 | Nil | ($ 890) |

**Note** The 1 percent credit described in Paragraph 21-121 would be claimed in the first quarter. Note that, in Quarter 3, when current expenditures are equal to the assumed 24.4 percent of fully taxable sales, the regular method and the Quick Method produce identical results. In Quarter 2, when current expenditures are below 24.4 percent, the Quick Method results in a lower amount payable. In contrast, in Quarter 4, when current expenditures exceed 24.4 percent, the Quick Method results in a higher amount payable.

More generally, when current expenditures, as a percent of fully taxable sales, are normally less than the percentage assumed in the Quick Method rate, use of the Quick Method is a desirable alternative. In contrast, when such expenditures normally exceed the assumed rate, the use of the Quick Method is not advantageous as it will result in a higher amount payable.

## Quick Method Categories

21-117. Conceptually, an equitable application of the Quick Method would require a large number of different rates in order to reflect the various cost structures that are present in different lines of business. However, this was clearly not a practical alternative, particularly since the goal of the Quick Method was simplification. Given this, the government decided to have rates for only two broad categories.

21-118. The categories to which the two rates are applied can be described as follows:

**Businesses That Resell Goods** These businesses have a lower remittance rate to reflect a higher percentage of eligible costs. In order to use these rates, the cost of goods purchased for resale (GST/HST inclusive) in the previous year must be equal to 40 percent or more of the revenue from sales of taxable supplies for that year (GST/HST inclusive). Examples of types of businesses eligible for this low rate include grocery and convenience stores, hardware stores, gas service stations, antique dealers, and clothing stores.

**Service Providers** These higher rates (double the resellers') apply to service businesses such as consultants (other than financial), hair salons, restaurants, dry cleaners, travel agents, and taxi drivers. Since legal, accounting, and financial consulting businesses are not eligible for the Quick Method, they cannot use these rates.

## Specific Quick Method Remittance Rates

21-119. As noted in the introduction to this Chapter, in addition to the GST rate of 5 percent that is used in provinces that do not participate in the HST program, there are two different HST rates as of January 1, 2019:

- 13 percent in Ontario
- 15 percent in New Brunswick, Newfoundland, Nova Scotia, and Prince Edward Island

21-120. As the Quick Method is designed to approximate the results under the regular method of calculating GST or HST, different Quick Method remittance rates are required in each of these situations. The relevant rates are as shown in Figure 21-4.

**Figure 21 - 4**
**Quick Method Remittance Rates As At January 1, 2019 (Excluding Quebec)**

| GST/HST Rate | Businesses That Purchase Goods For Resale | Service Providers |
|---|---|---|
| GST Only At 5% (B.C., Alberta, Manitoba, and Saskatchewan) | 1.8% | 3.6% |
| HST At 13% (Ontario) | 4.4% | 8.8% |
| HST At 15% (Newfoundland, Nova Scotia, New Brunswick and Prince Edward Island) | 5.0% | 10.0% |

21-121. Two things should be noted about these rates:

1. In the application of all of the rates in Figure 21-4, there is a credit equal to 1 percent of the first $30,000 of GST/HST inclusive sales in the year ($300 maximum).

2. These are the rates that are used by a business in the specified province that has all of its activities in that province. For businesses that deliver supplies in provinces other than their province of residence, calculations can be quite a bit more complicated. The CRA provides detailed information in its guide, "Quick Method Of Accounting For GST/HST" (RC4058).

### Example Of Quick Method

21-122. As an example of the Quick Method, consider a quarterly filing office supply store, located and operating only in Alberta, with annual taxable sales of less than $400,000. Its first quarter taxable sales were $40,000, resulting in GST included sales of $42,000 [(105%)($40,000)]. Purchases of inventory totaled $26,600 before GST. Qualifying capital expenditures during the first quarter were $3,000 before GST. Under the regular method, the first quarter GST payable would be calculated as follows:

| | |
|---|---|
| Sales [(5%)($40,000)] | $2,000 |
| Purchases [(5%)($26,600)] | ( 1,330) |
| Capital Expenditures [(5%)($3,000)] | ( 150) |
| First Quarter GST Payable - Regular Method | $ 520 |

21-123. Alternatively, the first quarter GST payable, as determined by the Quick Method, is calculated as follows:

| | |
|---|---|
| Basic Tax [(1.8%)(105%)($40,000)] | $756 |
| Credit On First $30,000 [(1%)($30,000)] | ( 300) |
| Subtotal | $456 |
| Input Tax Credit On Current Expenditures | Nil |
| Input Tax Credits On Capital Expenditures [(5%)($3,000)] | ( 150) |
| First Quarter GST Payable - Quick Method | $306 |

21-124. The Quick Method can be preferable, even if adequate data is available to make the calculations under the regular method. For example, a freelance writer, operating out of his principal residence, is not likely to have significant expenditures that qualify for input tax credits. In this case, the Quick Method may result in a smaller net GST payment than the regular calculation of actual GST collected, less input tax credits. It will certainly be less time consuming to file his GST return since input tax credit information on non-capital expenditures will not be needed.

## Exercise Twenty-One - 6

**Subject:** Quick Method

Robbins Hardware sells only fully taxable supplies to customers in Alberta which does not participate in the HST program and has no provincial sales tax. During the first quarter of the year, the business has sales of $42,500, before the inclusion of GST. They have taxable purchases totaling $21,000 before GST. They do not make any capital expenditures during the quarter. Using the Quick Method, determine the GST that is payable for the quarter.

## Exercise Twenty-One - 7

**Subject:** Quick Method

Guy's Boots sells only fully taxable shoes and boots to customers in Ontario where the HST rate is 13 percent. During the first quarter of the year, Guy's Boots has sales of $56,100, before HST. Current expenses, all of which were subject to HST, total $23,400 (before HST). Due to a major renovation of the store, Guy's Boots has capital expenditures of $42,000 (before HST). Compare the use of the Quick Method and the regular method for this quarter.

**SOLUTIONS available in print and online Study Guide.**

**We suggest you work Self Study Problems Twenty-One-5 and 6 at this point.**

## Small Suppliers Exemption

21-125. This is covered beginning at Paragraph 21-84 and will not be repeated here.

## Simplified Input Tax Credit Method

21-126. A method for claiming input tax credits and rebates is available to registrants with annual GST/HST taxable sales, including those of associated businesses, of $1,000,000 or less in the preceding year. An additional requirement is that annual GST/HST taxable purchases total no more than $4,000,000.

21-127. Rather than tracking GST/HST paid on each purchase, the simplified method bases input tax credits on the total GST/HST inclusive amounts of fully taxable purchases. This amount would also include any non-refundable provincial sales taxes paid on taxable supplies. Once this total is established, it is multiplied by the following factor:

**Factor** Applicable GST/HST Rate ÷ (100 Plus The Applicable GST/HST Rate)

**Examples** The factor in Alberta would be 5/105. The factor in Ontario would be 13/113.

21-128. The following items are excluded from the base to which the factor is applied:

- Capital expenditures for real property (these are tracked separately for input tax credit purposes).
- Purchases of zero-rated supplies, such as groceries and prescription drugs.
- Purchases of exempt supplies, such as interest payments.
- Purchases made outside Canada, which are not subject to GST/HST.
- Purchases from non-registrants.
- Refundable provincial sales taxes (only in Quebec).
- Expenses not eligible for input tax credits (e.g., 50 percent of the cost of meals and entertainment).

21-129. There is no election required to use this method and it does not affect the calculation of the GST/HST on sales that must be remitted. The following example illustrates this method as applied in the province of New Brunswick.

**EXAMPLE** Garth Steel Ltd. operates solely in New Brunswick and Nova Scotia. Its only activities involve the provision of fully taxable supplies. During the current year, it has current expenditures of $75,000, real property expenditures of $145,000 and expenditures for capital property other than real property of $25,000. All of these figures are before HST which was charged on all of these expenditures. In addition, the Company paid salaries of $200,000.

**ANALYSIS** The Company's input tax credit for the current year would be as follows:

| | |
|---|---|
| HST Included Amounts For Taxable Expenditures Other Than Real Property [(115%)($75,000 + $25,000 + Nil)] | $115,000 |
| Factor (For New Brunswick and Nova Scotia) | 15/115 |
| Input Tax Credit On Taxable Expenditures | $ 15,000 |
| Input Tax Credit On Real Property Expenditure [(15%)($145,000)] | 21,750 |
| Input Tax Credit For The Current Year | $ 36,750 |

21-130. As noted, the simplified method base only includes purchases of fully taxable goods. A further restriction on the amounts claimed is that credits can be claimed only to the extent that the purchases included in the simplified method base are used to provide fully taxable or zero-rated goods and services. Where a supply is used to provide both taxable and exempt goods and services, the input tax credit claim must be pro-rated so that only the portion that applies to taxable goods and services is claimed.

### Exercise Twenty-One - 8

**Subject:** Simplified Input Tax Credit Method

Simplicity Inc. operates in Alberta where there is no provincial sales tax and no participation in the HST program. For the current year, the Company has GST inclusive sales of $315,000. It has GST inclusive purchases of merchandise and other current expenditures of $189,000. Capital expenditures consist of real property (land and a building) costing $150,000 and capital personal property totaling $50,000. These capital expenditure amounts are before the inclusion of GST. Using the simplified method of accounting for input tax credits, determine Simplicity's GST payable or refund for the current year.

**SOLUTION available in print and online Study Guide.**

# GST/HST Procedures And Administration

## GST/HST Returns And Payments

### *Timing Of Liability*

21-131. In general, the supplier becomes responsible for the tax at the earliest of when the invoice for goods or services is issued, when payment is received, and when payment is due under a written agreement. Following this rule, a registrant usually becomes responsible for remitting GST/HST in the reporting period in which a customer is invoiced, even if this is not the same period in which the cash is actually received.

21-132. Similarly, input tax credits for GST/HST payable to suppliers can be claimed in the reporting period invoices are issued, even if the supplier is paid in a later period.

**Figure 21 - 5**
**Assigned And Optional Reporting Periods**

| Threshold Amount Of Annual Taxable Supplies | Assigned Reporting Period | Optional Reporting Period |
|---|---|---|
| $1,500,000 Or Less | Annual | Monthly Or Quarterly |
| More Than $1,500,000 Up To $6,000,000 | Quarterly | Monthly |
| More Than $6,000,000 | Monthly | None |

## Taxation Year For GST/HST Registrants

21-133. Every registrant is required to have a "fiscal year" for GST/HST purposes. Normally, this fiscal year corresponds to the taxation year for income tax purposes. However, if registrants are using a non-calendar year for income tax purposes they have the option of using the calendar year or, alternatively, using their fiscal year for income tax purposes. For example, a company with a fiscal year ending on January 31, 2019 and with a quarterly filing requirement could choose a three month reporting period ending on January 31, 2019, or a three month reporting period ending on March 31, 2019. The GST/HST fiscal year determines the reporting periods and filing deadlines for GST/HST returns.

## Filing Due Date

21-134. All businesses and organizations that are registered to collect GST/HST are required to file a GST/HST return on a periodic basis, even if there is no activity during the relevant period. The CRA's My Business Account service can be used to file GST/HST returns online. Filing frequencies for the remittance of GST/HST are determined by the total annual taxable supplies made by the registrant and its associated entities. The normal periods, along with the options that are available on an elective basis, are shown in Figure 21-5.

21-135. A registrant may elect to have a shorter filing period than the one that is assigned for their amount of taxable supplies. This may be advantageous for registrants who normally receive a GST/HST refund, such as businesses with significant exports or zero-rated sales (e.g., pharmacies and grocery stores). On a practical note, it may be advantageous for some annual filers to choose to file quarterly as it would force the registrant to keep their records more up-to-date. This could help decrease the work and stress that some proprietors and small businesses face when they deal with their year end accounting. As discussed in the next Section, filing quarterly would also eliminate the need to calculate and pay GST instalments.

21-136. For monthly and quarterly filers, GST/HST returns are due one month after the end of the reporting period. In general, for annual filers, GST/HST returns are due three months after the year end. There is an extension to June 15 for annual filers who are individuals with business income and a December 31 fiscal year end. This is the same filing due date applicable to income tax returns for these individuals.

## Payments And Instalments

21-137. In general, payment of amounts owing are due when the GST/HST returns are due. This is one month after the end of the reporting period for monthly and quarterly filers, and three months after the year end for annual filers. For annual filers who are individuals with a June 15 filing due date, the payment due date is April 30. This means the filing due date and payment due date are the same as is applicable to income tax payable for these individuals.

21-138. Instalment payments are not required for monthly or quarterly filers. However, annual filers are required to make quarterly instalments if the GST/HST remitted for the previous fiscal year was $3,000 or more. Each instalment will be one-quarter of the net tax owing from the previous year. These instalments are due one month after the end of each quarter. For example, calendar year filers are required to make instalments by April 30, July

31, October 31, and January 31. For annual filers below the $3,000 threshold, the net tax is due on the GST/HST return filing due date.

### Interest

21-139. If the GST/HST return shows an amount owing and it is not paid by the due date, interest is assessed. Interest is also assessed on late or deficient instalments. The applicable rates are the same as those used for income tax purposes:

- on taxes owed to the government, the rate is the prescribed rate plus 4 percent; and
- on amounts owed to the taxpayer, the rate is the prescribed rate plus 2 percent.

21-140. As is the case with interest on late income tax instalments, interest paid on late GST/HST payments is not deductible.

### Late Filing Penalty

21-141. The GST/HST late filing penalty is equal to one percent of the unpaid amount, plus one-quarter of one percent per month for a maximum of 12 months. Unlike the income tax situation, there is no doubling of this penalty for a second offense.

## Associated Persons

21-142. You may have noticed that there are a number of GST/HST rules that are related to the amount of supplies delivered during the period. In order to prevent the avoidance of these rules (e.g., splitting a business into two parts so that each would qualify for the Quick Method), GST/HST legislation has rules for associated persons.

21-143. Two or more persons are associated for GST/HST purposes where there is substantial common ownership. For example, if one corporation controls another, the two corporations are associated. An association can exist between two or more corporations, between an individual and a corporation, and among an individual, partnership, trust and corporation.

21-144. While associated persons file separate GST/HST returns, they must combine their total taxable sales of goods and services in certain situations, such as when determining:

- whether they qualify for the small supplier's exemption,
- whether they are eligible for the Quick Method of accounting,
- whether they are eligible for the simplified method of calculating input tax credits,
- the required filing frequency of their returns (i.e., monthly, quarterly or annual).

## Refunds And Rebates

21-145. In a period during which input tax credits exceed GST/HST collections, a refund may be claimed in the GST/HST return for that period. Provided all required returns have been filed and are up to date, interest on unpaid refunds starts accruing 30 days after the later of the last day of the reporting period and the day after the registrant's return is filed.

21-146. The *Excise Tax Act* also provides for a number of rebates of the GST/HST paid by consumers under certain circumstances. For example, if a GST/HST amount is paid in error, or by a foreign diplomat, a rebate of the GST/HST may be claimed on a General Rebate Application Form. Our coverage of the GST/HST rebate for new housing begins in Paragraph 21-167.

## Books And Records

21-147. For GST/HST purposes, every registrant must keep adequate books and records. This requirement is found in ETA 286(1). Such records must be maintained at the registrant's place of business or at the individual's residence in Canada.

21-148. All books and records, along with the accounts and vouchers necessary to verify them, must be kept for a period of six years from the end of the last taxation year to which they relate. This is the same record retention limit that is applicable for income tax purposes.

# Appeals

## *Informal Procedures*

21-149. As is the case with income tax disputes, the usual first step in disputing an assessment or reassessment is to contact the CRA. In many cases the proposed change or error can be corrected or resolved through telephone contact or by letter. In order to authorize a person or firm to represent a GST registrant in such disputes, a consent form must be signed and filed with the CRA.

## *Notice Of Objection*

21-150. If the informal contact with the CRA does not resolve the issue in question, the taxpayer should file a notice of objection. For GST/HST purposes, a formal notice of objection procedure is required.

21-151. In GST/HST disputes, the notice of objection must be filed within 90 days of the date on the notice of assessment. Unlike the situation with income tax objections, there is no general extension of this time period for GST registrants who are individuals, nor is there any extension for individual GST registrants in the year of their death. Failure to meet the 90 day deadline may result in the taxpayer losing all rights to pursue the matter in question.

21-152. On receiving the notice of objection, the Minister is required to reply to the GST registrant:

- vacating the assessment;
- confirming the assessment (refusing to change);
- varying the amount of the assessment; or
- reassessing.

21-153. Unresolved objections will be subject to review by the Assistant Director of Appeals in each Tax Services Office. These reviewers are instructed to operate independently of the assessing divisions and should provide an unbiased second opinion. If the matter remains unresolved after this review, the taxpayer must either accept the Minister's assessment or, alternatively, continue to pursue the matter to a higher level of appeal. The taxpayer has the right to bypass this notice of objection procedure and appeal directly to a higher level.

21-154. As noted in Chapter 2, in income tax disputes, the Minister cannot institute collection procedures until after the notice of objection period has expired. When dealing with GST/HST disputes, collection procedures are not delayed by the objection process. This more aggressive approach is allowed by GST/HST legislation and probably reflects the fact that the government considers GST/HST balances assessed as amounts collected in trust by the registrant on behalf of the government.

## *Tax Court Of Canada, Federal Court Of Appeal, And The Supreme Court Of Canada*

21-155. Procedures for handling GST/HST disputes in these courts are basically the same as the procedures for handling income tax disputes. These procedures are described in Chapter 2 and the description will not be repeated here.

# General Anti-Avoidance Rule

21-156. The GST/HST legislation includes a general anti-avoidance rule (GAAR). This rule is found under Section 274 of the *Excise Tax Act* and is very similar to the GAAR found in the *Income Tax Act*.

21-157. While the GST/HST GAAR is intended to prevent abusive tax avoidance transactions, it is not intended to interfere with legitimate commercial transactions. If a transaction is considered by the CRA to be an avoidance transaction, the tax consequences of the transaction may be adjusted. This could involve denying an input tax credit, allocating an input tax credit to another person, or recharacterizing a payment. But, as with the application of the income tax GAAR, it does not apply if a transaction is undertaken primarily for bona fide purposes other than to obtain a GST/HST benefit.

# Employee And Partner GST/HST Rebate

## General Concept

21-158. Many of the expenses employees can deduct against employment income include a GST/HST component. If the individual was a GST registrant earning business income, these GST/HST payments would generate input tax credits. However, employment is not considered to be a commercial activity and, as a consequence, employees who have no separate commercial activity cannot be registrants. This means that they will not be able to use the usual input tax credit procedure to obtain a refund of GST/HST amounts paid with respect to their employment expenses. A similar analysis applies to partners who have partnership related expenses that are not included in partnership net income or loss.

21-159. The Employee and Partner GST/HST Rebate allows employees and partners to recover the GST/HST paid on their employment or partnership related expenditures, including vehicles and musical instruments, in a way that is similar to the input tax credits that they could have claimed if they were GST registrants. Form GST370 is used to claim the GST/HST rebate and is filed with the employee or partner's income tax return.

21-160. To qualify for this rebate, the individual must be either an employee of a GST registrant, or a member of a partnership that is a GST registrant. Employees of financial institutions are not eligible for the rebate. However, employees of charities, not-for-profit organizations, universities, school boards, and municipalities are eligible as long as the organizations that they work for are registered. In addition, employees of provincial governments, Crown corporations, and the federal government qualify for the rebate. To claim the rebate, the individual must have unreimbursed expenses on which GST/HST was paid that are deductible against employment or partnership income.

## Calculating The GST/HST Rebate Amount

21-161. The GST/HST rebate is based on the GST/HST amounts included in those costs that can be deducted in the determination of employment income. In terms of calculations, this is accomplished by multiplying the GST/HST and non-refundable PST included in the cost by a fraction in which the GST/HST rate is the numerator and 100 plus the GST/HST rate is the denominator.

**EXAMPLE** Marcia Valentino is employed in British Columbia. She has deductible cell phone expenses of $2,000. She paid $100 in GST (5%) and $140 in non-refundable PST (7%). She deducted $2,240 in her calculation of employment income.

**ANALYSIS** Ms. Valentino's rebate would be $107 [($2,240)(5/105)]. This is more than the $100 in GST she paid as the rebate base includes the non-refundable PST.

21-162. Eligible expenses exclude expenses for which a non-taxable allowance was received, zero-rated and exempt supplies, supplies acquired outside of Canada, supplies acquired from non-registrants, and expenses incurred when the employer was a non-registrant.

## Example

21-163. The following simple example illustrates the calculation of the GST/HST rebate for an employee:

**EXAMPLE** Tanya Kucharik is a very successful sales manager employed in Ontario. She used her car 93 percent and her cell phone 80 percent for employment related purposes during 2019. She claimed the following expenses on Form T777, Statement of Employment Expenses, for 2019 (all HST taxable amounts include applicable HST at 13 percent):

| | |
|---|---|
| Cell phone charges (80%) | $ 1,200 |
| Gas, maintenance and car repairs (93%) | 17,500 |
| Insurance on car (93%) | 1,023 |
| Capital cost allowance (CCA) on car (93%) | 3,100 |

The car on which the CCA was deducted was purchased during 2019. She did not own a car prior to this purchase. Note that car insurance is a financial service on which no HST is charged as it is an exempt supply.

**ANALYSIS** On Form GST370, her GST/HST rebate would be as follows:

| | Eligible Expenses | HST Rebate (13/113) |
|---|---|---|
| Eligible Expenses Other Than CCA ($1,200 + $17,500) | $18,700 | $2,151 |
| Eligible CCA On Which HST Was Paid | 3,100 | 357 |
| Totals | $21,800 | $2,508 |

21-164. The employment related expenses that are listed in this calculation will be deducted in Ms. Kucharik's income tax return for 2019. Under normal circumstances, the HST rebate for 2019 expenses will be claimed in Ms. Kucharik's 2019 tax return. As a result, this amount will be received in 2020, either as part of the 2019 refund or as a decrease in the amount owed for 2019.

21-165. As the rebate constitutes a reduction in the incurred costs that were deducted by the employee, an adjustment of the deduction is required for amounts that are received. This is accomplished by including the $2,151 HST rebate on expenses other than CCA in Net Income For Tax Purposes in the year in which it is received (2020 in Ms. Kucharik's case). In similar fashion, the amount of any rebates received that related to CCA ($357) will be deducted from the capital cost of the relevant asset in the year in which it is received (again 2020, in the case of Ms. Kucharik). The GST/HST rebate she received in 2019 that was related to her 2018 income tax return would be added to her 2019 Net Income For Tax Purposes.

21-166. While the rebate is normally claimed in the return in which the expenses are deducted, it can be claimed in any income tax return submitted within four years of the year in which the expenses are claimed.

**We suggest you work Self Study Problem Twenty-One-7 at this point.**

# Residential Property And New Housing Rebate

## General Rules For Residential Property

21-167. Residential real estate is an area of considerable importance to most Canadians. Given this, it is not surprising that residential real estate is provided special treatment under the GST/HST legislation.

21-168. In somewhat simplified terms, GST/HST applies to residential property only on the first sale of a new home. If a new home is resold in substantially unaltered condition, no GST/HST will apply on this later transaction. If the homeowner undertakes renovations, such as a kitchen, GST/HST will be charged on the materials and other costs going into the renovation. By contrast, if a used home is acquired and substantially renovated before the home is lived in by the purchaser, the acquisition will be treated as a new home purchase and the transaction will be taxable for GST/HST purposes. The CRA defines a substantial renovation as one in which 90 percent or more of the interior of an existing house is removed or replaced.

## New Housing Rebate

### *Calculating The Rebate*

21-169. While sales of new homes attract both GST and HST at the applicable rates, rebates of the amount paid are available. In provinces that do not participate in the HST program, the rebate is equal to 36 percent of the GST paid. However, the situation with participating HST provinces is much more complex, including provincial variations in the HST rebate percentage, as well as the price thresholds. Because of this additional complexity, we will deal only with non-participating provinces in this section. The CRA has a detailed guide covering the many complexities in this area, "GST/HST New Housing Rebate" (RC4028).

21-170. With its traditional aversion to providing tax incentives related to luxury expenditures, the government has limited this rebate to a maximum value of $6,300, the amount of the GST rebate on a $350,000 home [(36%)(5%)($350,000) = $6,300]. In addition, the rebate is phased out for houses costing more than $350,000 and completely eliminated for homes costing more than $450,000. All of these amounts are before the inclusion of GST.

21-171. The government's policy goals are accomplished by calculating the rebate as follows:

**[A][($450,000 - B) ÷ $100,000],** where

**A** = The lesser of 36 percent of the GST paid and $6,300; and
**B** = The greater of $350,000 and the cost of the home.

21-172. A simple example will illustrate the application of this formula.

**EXAMPLE** Gilles and Marie Gagnon acquire a new home with a cost of $420,000, paying an additional amount of $21,000 [(5%)($420,000)] in GST.

**ANALYSIS** As 36 percent of the GST paid is $7,560, an amount in excess of the limit of $6,300, the rebate available to Gilles and Marie will be $1,890 {[$6,300][($450,000 - $420,000) ÷ $100,000]}.

### *Implementing The Rebate*

21-173. While the GST could be included in the price paid by the home purchaser, with that individual claiming the rebate, this is not the usual industry practice. The usual practice is for the builder to charge the purchaser an amount that is net of the rebate, with the purchaser assigning rights to the GST rebate to the builder. In the case of our example, the builder would charge Gilles and Marie $439,110 ($420,000 + $21,000 - $1,890). From the point of view of convenience for the purchaser, this appears to be an appropriate practice.

**We suggest you work Self Study Problems Twenty-One-8 and 9 at this point.**

# Sale Of A Business

## Sale Of Assets

21-174. The sale of the assets of a business is a taxable supply for GST purposes. This applies regardless of the legal form in which the business is carried on. However, where "all or substantially all" of the assets that the purchaser needs to carry on a business are being acquired by the purchaser, the GST/HST legislation allows the vendor and purchaser to elect to treat the supply as if it were zero-rated.

21-175. This applies to businesses that provide exempt supplies, as well as to businesses that provide fully taxable or zero-rated supplies. The use of the election is not permitted when the vendor is a registrant and the purchaser is a non-registrant. However, without regard to the type of business, the election can be used when both the vendor and the purchaser are not GST registrants.

21-176. If the election is made, the vendor does not collect GST/HST on the sale of taxable supplies, and the purchaser cannot claim an input tax credit. As a result, a transfer of the

assets of a business can be made without payment of GST/HST. If the election is not made, GST/HST will be collected on the sale. Offsetting input tax credits may be available to the purchaser through the normal input tax credit procedures.

21-177. In determining whether "all or substantially all" of the assets necessary to carry on the business are transferred, the CRA relies on a 90 percent or more test. The CRA has several policy papers on this election in order to provide registrants with guidance in determining compliance with the 90 percent or more test.

## Sale Of Shares

21-178. As a general rule, the sale of shares in a corporation is not a taxable supply because, under the GST/HST legislation, the sale of a financial instrument such as a share is an exempt supply. As a result, share for share exchanges are not taxable for GST/HST purposes.

## Other Situations

### Section 85 Rollovers

21-179. When property used in a commercial activity is rolled into a corporation under Section 85 of the *Income Tax Act*, the rollover is a taxable transaction for GST/HST purposes. For example, if a sole proprietorship or partnership transfers property when a business is incorporated, the rollover of property will be deemed to be a taxable supply for consideration equal to the fair market value of the property. This amount will then be subject to GST/HST.

21-180. A joint election may be available to avoid any related GST/HST liability, providing the vendor sells or transfers all, or substantially all (i.e., 90 percent or more) of the assets that can reasonably be regarded as being necessary for the purchaser to carry on the business. A further requirement is that, if the vendor is a GST registrant, the purchaser must also be a GST registrant.

21-181. If the transfer of property is a taxable supply, GST/HST will be payable on the total fair market value of the share and non-share consideration exchanged for the property, with the elected amount under Section 85 of the *Income Tax Act* being irrelevant. If the transferred property is subsequently used in commercial activities, an input tax credit may be claimed by the transferee for any GST/HST paid on the transfer of the property.

### Amalgamations, Mergers, Winding-Up Of A Business

21-182. Where two corporations are merged or amalgamated into a single corporation, or the activities of one corporation are wound up through a merger with another corporation, the new corporation is generally treated for GST/HST purposes as a person separate from each of the predecessor corporations.

21-183. If the transfer of assets involves an amalgamation under ITA 87 or a winding-up under ITA 88(1), the transfer of assets is deemed not to be a taxable supply for GST/HST purposes and no election is required. The asset or property transferred on the merger or amalgamation is not a taxable supply under the legislation. As a result, there are no GST/HST consequences.

### Transfers Within Corporate Groups

21-184. Transfers of goods and services between members of corporate groups will normally attract GST/HST. However, an election can be made to have such transfers deemed to be made for nil consideration (only for GST/HST purposes), resulting in no required payment of GST/HST.

21-185. The conditions for this election are quite strict and require either the ownership of at least 90 percent of the voting shares of one corporation by the other, or that the companies be sister corporations owned by a parent corporation. In addition, the electing corporations must be Canadian residents and the supplies involved must be used exclusively (more than 90 percent) in a commercial activity.

### Holding Companies

21-186. Although many holding companies only hold shares or debt and do not carry on a "commercial activity" in the usual sense, GST/HST legislation allows holding companies to register for the GST/HST and claim input tax credits if they hold shares or debt in another company that owns property that is used at least 90 percent for commercial activities. These provisions allow holding companies to obtain refunds of GST/HST paid on the purchase of property or services solely related to the holding of the shares or debt.

### Ceasing To Carry On Business

21-187. When a person ceases to carry on a commercial activity, or becomes a small supplier and, as a result, ceases to be a registrant, the person is deemed to have sold all assets at fair market value upon deregistration. If the assets were used for commercial purposes, GST/HST will be payable on the deemed dispositions.

## Specific Applications

21-188. There are many GST/HST procedures that are specific to certain types of transactions or organizations (e.g., import transactions or charitable organizations). Detailed coverage of such procedures clearly goes beyond the scope of a text which focuses on income taxation. However, we do believe that it is useful to provide you with some general information on some of these specific areas:

- **Imports** In general, imports are subject to GST/HST.
- **Exports** In general, exports of goods and services from Canada are zero-rated. This means that while no GST/HST is charged on exports, input tax credits can be claimed by the exporter.
- **Charities** In general, the revenues of registered charities are exempt from GST/HST. However, revenues from commercial activities (e.g., museum gift shop revenues) are fully taxable subject to the small supplier threshold of $50,000 (a special rule for charities expands the small supplier threshold from $30,000 to $50,000). A special provision provides for a 50 percent rebate of the federal GST paid on purchases related to exempt activities. In the HST provinces, there is a 50 percent rebate of the federal portion of the HST on such purchases, as well as an additional rebate of the provincial portion of the HST. The provincial rebate varies from province to province.
- **Not-For-Profit Organizations** In general, the revenues of not-for-profit organizations are fully taxable (in contrast to the situation with registered charities). However, exemptions are provided for such services as subsidized home care and meals on wheels. As was the case with registered charities, qualifying not-for-profit organizations receive a 50 percent rebate of the federal GST paid on purchases related to exempt activities. In the HST provinces, there is a 50 percent rebate of the federal portion of the HST on such purchases, as well as an additional rebate of the provincial portion of the HST. The provincial rebate varies from province to province.

  To be classified as a qualifying not-for-profit organization, the organization must receive significant government funding. Such funding is regarded as significant when at least 40 percent of total revenues come from this source.
- **Government Bodies** All federal government departments receive a full rebate of the GST/HST paid on purchases by means of a tax remission order. Each provincial and territorial government is registered as a separate entity for the GST/HST, and uses "certificates" to receive point of purchase relief from the GST/HST.
- **Crown Corporations** Crown corporations are not GST/HST exempt and are registered as separate persons for purposes of the GST/HST.
- **Municipalities, Universities, Schools And Hospitals (MUSH)** These organizations are classified as "Public Institutions" in the GST/HST legislation and, except where there

are specific exemptions, their revenues are fully taxable. Examples of exemptions include property taxes for municipalities, course fees for universities, and medical services for hospitals. Rebates for the federal GST paid on purchases related to exempt activities are available, with the rates varying from 67 percent for universities to 83 percent for hospitals to 100 percent for municipalities. In the HST provinces, the same rebates are available for the federal portion of the HST, as well as an additional rebate of the provincial portion of the HST. The provincial rebate varies from province to province.

- **Financial Institutions** The GST/HST legislation defines financial institutions to include "listed" financial institutions, such as banks and insurance companies, as well as deemed financial institutions (e.g., businesses with financial revenues exceeding specified threshold levels). Revenues from providing financial services are designated as exempt. This means that, for an institution where the bulk of its revenues is from the provision of financial services, only limited input tax credits will be available.

21-189. These brief comments serve only to give a very general view of the approach taken to these specific types of transactions and organizations. If you are dealing with any of these applications you will, of course, have to consult a more specialized source of information.

# Partnerships And GST/HST

## General Rules

21-190. The ITA treats a partnership as a person only for the purpose of computing income or loss to its partners. The *Excise Tax Act* considers partnerships to be persons that are generally required to register for the GST/HST with respect to commercial activities. In addition, anything a partner does with respect to partnership activities is considered done by the partnership and not by the partners themselves.

21-191. The result is that it is the partnership, and not the partners, who is required to register for the GST/HST with respect to partnership business. Given this, partnerships are required to collect and remit GST/HST on taxable supplies and are eligible for input tax credits. Partners are jointly and severally liable however with respect to GST/HST that relates to the partnership business.

## Partner Expenses

21-192. Non-reimbursed expenditures for property or services incurred personally by individual partners, which relate to the partnership business and that are deductible for income tax purposes by the partners, are generally eligible for the Employee And Partner GST/HST Rebate. Such property and services include office expenses, travel expenses, meals and entertainment, parking, lodging and CCA on certain capital assets such as motor vehicles. This rebate was discussed beginning in Paragraph 21-158.

21-193. A partner can only claim a rebate to the extent that the partnership could have otherwise claimed an ITC if it had incurred the expense directly. This means that, if a partnership provides only exempt goods or services, the partners would not be eligible to claim a GST/HST partner rebate for expenses that they deduct from their share of partnership income.

## Disposition Of A Partnership Interest

21-194. A partnership interest may be disposed of or acquired in many situations. These include the admission of a new partner or retirement of an existing partner. A partnership interest is considered a "financial instrument" and is exempt from the GST/HST. In addition, any legal and accounting fees related to the acquisition or disposition of a partnership interest are not eligible for an input tax credit since they relate to a financial instrument and not to the partnership's business. Finally, drawings and capital contributions that specifically relate to a partnership interest are considered "financial services" and are also exempt from the GST/HST.

## Transfers Between Partners And Partnerships

21-195. In general, there is no GST/HST counterpart to the rollover rule that allows property to be transferred by a partner to a partnership on a tax deferred basis. An exception to this is the case where a business is being transferred and 90 percent or more of the property that is necessary to carry on that business is also transferred. In such cases, the transfer is not subject to GST/HST as long as both transferor and transferee are registrants.

21-196. Transfers of property between partnerships and partners may be subject to GST/HST, generally depending on the status of the transferor and transferee as registrants and whether they are engaged in commercial activities. GST/HST is not applicable to transfers of cash, accounts receivable, or debt however, since these are either not considered property for GST/HST purposes or are considered exempt financial services.

## Reorganization Of The Partnership

21-197. The admission of new partners or retirement of existing partners that terminate the old partnership and result in the creation of a new partnership will not cause the new partnership to register for GST/HST as a new person. As a result, there are no GST/HST implications on the transfer of the old partnership property to the new partnership.

21-198. There are no GST/HST implications to the new partnership where a partnership has ceased to exist, more than half of its members form a new partnership, and transfer 90 percent or more of the property they receive on the cessation of the old partnership to the new partnership. The new partnership is considered to be a continuation of the old partnership for GST/HST purposes.

# Trusts And GST/HST

21-199. A trust is included in the definition of person under the *Excise Tax Act* and, as a consequence, a trust that is engaged in commercial activities is required to register and collect GST/HST on taxable supplies. However, an interest in a trust is considered to be a financial instrument, so the sale of an interest in a trust is an exempt financial service and is not subject to GST/HST.

21-200. A distribution of trust property by a trustee to a beneficiary of a trust is treated as a supply by the trust. The consideration is the same as proceeds of disposition for purposes of the *Income Tax Act*. Distributions of non-commercial property by a trust in the process of the settlement of an estate are generally not considered to be in the course of commercial activities of the trust and are GST/HST exempt. Similarly, a distribution of financial securities is GST/HST exempt as a financial service. The GST/HST only applies to properties acquired by the trust that are used in a commercial activity.

21-201. Where property is settled through the use of an inter vivos trust, including an alter ego or joint spousal or common-law partner trust, the consideration for the property transferred is deemed to equal the amount determined under the *Income Tax Act*. The supply is considered to be made at fair market value and GST/HST is payable on all taxable supplies. However, when an estate is settled, an election can be filed to distribute any property of a deceased registrant without the payment of GST/HST. In this situation, the beneficiary of the deceased's estate must be a registrant, and the beneficiary is deemed to have acquired the property for use exclusively in a commercial activity.

**Additional Supplementary Self Study Problems Are Available Online.**

## Key Terms Used In This Chapter

21-202. The following is a list of the key terms used in this Chapter. These terms, and their meanings, are compiled in the Glossary located at the back of the Study Guide.

| | |
|---|---|
| Capital Personal Property | New Housing GST/HST Rebate |
| Commercial Activity | Partner And Employee GST/HST Rebate |
| Commodity Tax | Quick Method |
| Employee And Partner GST/HST Rebate | Registrant |
| Exempt Goods And Services | Simplified ITC Accounting |
| Fully Taxable Goods And Services | Small Suppliers Exemption |
| Goods And Services Tax (GST/HST) | Supply |
| Harmonized Sales Tax (HST) | Transaction Tax |
| Input Tax Credit (ITC) | Value Added Tax (VAT) |
| MUSH | Zero-Rated Goods And Services |

## Problems For Self Study (Online)

To provide practice in problem solving, there are Self Study and Supplementary Self Study problems available on MyLab Accounting.

Within the text we have provided an indication of when it would be appropriate to work each Self Study problem. The detailed solutions for Self Study problems can be found in the print and online Study Guide.

We provide the Supplementary Self Study problems for those who would like additional practice in problem solving. The detailed solutions for the Supplementary Self Study problems are available online, not in the Study Guide.

The .PDF file "Self Study Problems for Volume 2" on MyLab contains the following for Chapter 21:

- 9 Self Study problems,
- 6 Supplementary Self Study problems, and
- detailed solutions for the Supplementary Self Study problems.

## Assignment Problems

(The solutions for these problems are only available in the solutions manual that has been provided to your instructor.)

### *Assignment Problem Twenty-One - 1*

***(Turnover Tax vs. GST)***

You have been appointed tax policy advisor to a country that has never used taxes on goods or services. Because of the increasing need for revenues, the Finance Minister, Maximus Surplus, is committed to introducing a sales tax. He is considering two alternatives:

- A 5 percent value added tax using the same invoice-credit approach that has been incorporated into Canada's GST system.
- A turnover tax that is applied as goods move from the raw materials supplier, to the manufacturer, to the wholesaler, to the distributor, to the retailer, and finally to the consumer. Minister Surplus would like you to calculate the turnover tax rate that would produce the same amount of revenue as the alternative 5 percent GST.

In illustrating this to Minister Surplus, he would like you to assume a sale price of $250, plus tax, by the raw materials supplier to the manufacturer. At this and subsequent turnover points, he would like you to assume a markup by each seller equal to 40 percent of their before tax cost.

**Required**: Provide the requested information with an explanation of your calculations.

### *Assignment Problem Twenty-One - 2*

***(Registration Requirements)***

Chantelle Chance is a hairdresser who started in business on October 1, 2018 and has not registered to collect the GST. Quarterly revenues from her business for her first year of operation were as follows:

| | |
|---|---:|
| October To December, 2018 | $ 4,000 |
| January To March, 2019 | 6,500 |
| April To June | 9,000 |
| July To September | 9,500 |
| Total For Year Ending September, 2019 | $29,000 |

For the quarter ending December 31, 2019, business revenues were $11,500.

**Required**: Advise Chantelle if registration for the GST is required and include the reasons for your answer. If required, state when GST collection should start and by what date registration must be completed.

## Assignment Problem Twenty-One - 3

### (Registration Requirements And GST Collectible)

After years of study, Martin believes that he has developed a process for making perfect macaroons. He also believes that there is significant demand for these tasty treats. Based on this, on March 1, 2019, he opens a retail operation in an Edmonton mall.

His new business will have a December 31 year end. All of his sales will be in Alberta, a province that has no provincial sales tax. Martin wants to delay collecting GST for as long as legally possible.

Martin's Macaroons had monthly sales for 2019 as follows:

| Month | Sales |
|---|---|
| March | $ 2,420 |
| April | $ 4,650 |
| May | 13,780 |
| June | 13,240 |
| July | $13,780 |
| August | 15,760 |
| September | 16,480 |
| October | $16,670 |
| November | 18,490 |
| December | 21,750 |

**Required**:

A. Indicate the date on which Martin's Macaroons will be required to start collecting GST and the date by which Martin will be required to register.

B. Assume that Martin's Macaroons has elected to file GST on a quarterly basis . Calculate the GST collectible for each quarter of 2019 and specify the due date of each GST return and payment.

C. Assume that Martin's Macaroons files GST on an annual basis. Calculate the GST collectible for 2019 and specify the due date of the GST return and payment.

D. Assume that in January, 2019, Martin comes to you for advice on when he should register for the GST. What factors should he consider?

## Assignment Problem Twenty-One - 4

### (Regular GST Return)

Lassen Ltd., an Alberta corporation, is an annual filer for GST purposes. Alberta does not participate in the HST program and does not have a provincial sales tax.

The following is a summary of the financial statement information for the current year. All amounts are presented without the inclusion of applicable GST.

| | | |
|---|---|---|
| Sales | | $5,700,000 |
| Less Expenses: | | |
| Cost Of Goods Sold | ($2,600,000) | |
| Amortization Expense | ( 720,000) | |
| Salaries And Wages | ( 640,000) | |
| Interest Expense | ( 120,000) | |
| Other Pre-Tax Expenses | ( 370,000) | |
| Income Taxes | ( 240,000) | ( 4,690,000) |
| Net Income | | $1,010,000 |

**Other Information:**

1. Sales included $1,200,000 in exempt supplies and $2,400,000 in zero-rated supplies. The remaining sales were fully taxable for GST purposes.
2. All of the goods sold involved the provision of either fully taxable or zero-rated supplies. During the year, inventories of these goods decreased by $200,000. GST was paid on all goods that were purchased for resale during the year.
3. Capital expenditures for the year amounted to $4,000,000, with GST being paid on all amounts. Of this total, $3,000,000 was for an office building that will be used 40 percent for the provision of fully taxable or zero-rated supplies. The remaining $1,000,000 was for equipment that will be used 70 percent in the provision of exempt supplies. GST was paid on the acquisition of all assets on which amortization is being taken during the year.
4. All of the Other Expenses involved the acquisition of fully taxable supplies and were acquired to assist in the provision of fully taxable supplies. Included is $40,000 reimbursed to sales employees for meals while travelling for business.
5. Of the Salaries And Wages, 40 percent were paid to employees involved in providing exempt supplies.

**Required:** Calculate the net GST payable or refund that Lassen will remit or receive for the current year.

### *Assignment Problem Twenty-One - 5*

#### *(Regular HST Return)*

Conan's Comics is an unincorporated business owned by Conan Barbarian. All of its operations are located in Newfoundland. The HST rate in that province is 15 percent.

The business is an HST registrant that sells both fully taxable and zero-rated goods. In addition, Conan's Comics provides exempt services. The business is an annual filer for HST purposes.

The Income Statement for the current year is as follows. All amounts are before the addition of applicable HST.

| | | |
|---|---|---|
| Revenues: | | |
| Fully Taxable Goods | $643,431 | |
| Zero-Rated Goods | 311,412 | |
| Exempt Services | 416,253 | $1,371,096 |
| Less Expenses: | | |
| Cost Of Fully Taxable Goods Sold | ($489,567) | |
| Cost Of Zero-Rated Goods Sold | ( 203,642) | |
| Amortization | ( 106,911) | |
| Salaries And Wages | ( 62,435) | |
| Interest Expense | ( 16,243) | |
| Other Operating Expenses | ( 28,968) | ( 907,766) |
| Income Before Taxes | | $ 463,330 |
| Less: Federal And Provincial Income Taxes | | ( 157,243) |
| Net Income | | $ 306,087 |

**Other Information:**

1. Inventories of fully taxable goods decreased by $24,650 during this period, while inventories of zero-rated goods increased by $19,243. The zero-rated sales were generated by purchasing and selling zero-rated supplies.
2. Capital expenditures for this period amounted to $1,950,000, with HST being paid on all amounts. Of this total, $1,260,000 was for a building that will be used 35 percent for the

provision of fully taxable supplies and 25 percent for the provision of zero-rated supplies. The remaining $690,000 was for equipment that will be used 38 percent in the provision of fully taxable supplies and 27 percent for the provision of zero-rated supplies. HST was paid on the acquisition of all assets on which amortization is being taken during this period.

3. Of the Other Operating Expenses, 62 percent were related to the provision of fully taxable and 24 percent to the provision of zero-rated supplies.
4. Of the Salaries And Wages, 65 percent were paid to employees involved in providing exempt supplies.

**Required:** Calculate the net HST payable or refund that Conan's Comics will remit or receive for the current year.

## Assignment Problem Twenty-One - 6

### (Quick Method)

John, Alice, Alex, and Jerry Rangi are quadruplets. Their father financed an unincorporated business for each of them 3 years ago. They were each allowed to select their own line of business. As an incentive, their father has indicated that the child who owns the business that generates the most income in the first 5 years will receive a gift of $1,000,000 in cash.

All of the businesses are located in Ontario, with all of the revenues being generated in that province. As all of the business were expected to have taxable supplies well in excess of $30,000, each business was registered for the Ontario HST at its inception.

The siblings provide you with the following annual information for their businesses. All amounts are reported inclusive of HST. None of the sales or purchases were zero-rated or exempt, and none of the businesses made any capital expenditures during the year.

| | Type Of Business | Sales | Purchases |
|---|---|---|---|
| John | Computer Sales, Repairs And Tutoring | $ 103,960 | $ 26,160 |
| Alice | Bicycle Sales And Service | 194,360 | 159,330 |
| Alex | Menswear Sales And Custom Tailoring | 126,560 | 47,460 |
| Jerry | Tarot Card Reading And Cell Phone Sales | 84,750 | 41,810 |

The HST rate in Ontario is 13 percent. The Quick Method remittance rates are 4.4 percent for resellers and 8.8 percent for service providers. When calculating the applicable remittance rate, assume the sales and purchases of the previous year were equal to those of the current year.

**Required**: Recommend whether any of the businesses should use the Quick Method to calculate net HST remittances. Show all of your calculations.

## Assignment Problem Twenty-One - 7

### (Regular And Quick Method GST Returns)

Johnny Dangerous has successfully engaged in criminal activity since he was 12 years old. Financially, he has been very successful and, to date, he has no criminal record. All of his activity is carried out in Ontario. The HST rate for Ontario is 13 percent. The Ontario quick method rates are 4.4 percent for businesses that purchase goods for resale and 8.8 percent for service providers.

Early in his career, his father taught him that the notorious Chicago gangster Al Capone was sent to jail, not for his many murders and other illegal acts, but for tax evasion. Taking this lesson to heart, Johnny has been very diligent about filing both income tax returns and GST returns on time. For the 2019 taxation year, his activities fall into three categories:

**Contract Assassinations** Johnny accepts contracts for assassinations at a base rate of $15,000. He offers volume discounts and charges higher fees for particularly difficult cases. As he enjoys the work, Johnny handles all of this activity personally.

During 2019, his revenues from this work totaled $323,000. While he does not specifically advise his clients that they are paying HST, he files his GST return on the basis that the amounts collected are HST included.

**Export Of Illegal Drugs** A growing part of Johnny's activities involve exporting heroin and other illegal drugs to the U.S. market. His 2019 revenues from this activity totaled $113,000.

**Loan Sharking** As a service to his clients, he offers extremely high interest rate loans to individuals who cannot find other sources of financing. Revenue from this source totaled $87,000 for 2019.

Johnny has an assistant, Cruella Ratched, who works on a full time basis for his business. Since he lost his driver's licence two years ago, her duties include driving him to his jobs using her car. Her salary for 2019 is $85,000 which includes a $12,000 car allowance.

Johnny maintains an office which he rents for $4,000 per month, plus HST. During the year, miscellaneous office costs total $6,900 plus applicable HST. This includes $400 for business insurance. The furniture, fixtures and art in the office are leased at a cost of $2,000 per month, plus HST. Telephone and internet cost $125 per month, plus HST.

Johnny has calculated that these costs should be allocated to his three business activities as follows:

| | |
|---|---|
| Contract Assassinations | 65% |
| Export Of Illegal Drugs | 20% |
| Loan Sharking | 15% |

Expenditures specific to his various activities are as follows:

**Contract Assassinations** Johnny uses a Glock 9mm for this activity. He disposes of each gun after a single use, making this a significant cost of doing business. On January 1, 2019, he had 5 of these guns on hand. Their total capital cost was $3,101, plus HST and they had been allocated to Class 8. They were the only assets in this class and on January 1, 2019, the UCC for this Class was $2,792. During 2019, Johnny acquires an additional 19 guns at $549 each, plus HST. After using each weapon once, he disposes of 20 of his guns. There were no proceeds associated with the disposals.

His only other costs associated with this activity were for travel. Airline, hotel, and taxis totaled $12,000 plus HST. Meals while travelling totaled $7,492 plus HST.

**Export Of Illegal Drugs** Costs associated with this activity are as follows:

| | |
|---|---|
| Purchases Of Processing Equipment (Including HST) | $11,300 |
| Security Service For Lab (Including HST) | 5,650 |
| Shipping Costs (No HST - Using Illegal Immigrants) | 3,000 |
| Bribes To Customs Officials (No HST) | 4,500 |
| Cost Of Materials Exported (No HST) | 21,700 |

**Loan Sharking** Johnny used bank loans to finance these loans. Interest on these loans for 2019 was $12,600. When he experienced difficulties with collections he used a former World Wrestling Foundation champion to enforce the payment of the loans. Costs for this service for 2019 were $4,800 (no HST - small supplier).

**Required**:

A. Determine Johnny's HST payable (refund) for the year ending December 31, 2019, using the regular method of determination.

B. Determine whether Johnny can use the quick method for determining his HST payment or refund for 2019.

C. Without regard to your conclusion in Part B, determine Johnny's HST payable (refund) for the year ending December 31, 2019, using the quick method.

### *Assignment Problem Twenty-One - 8*
#### *(Regular And Quick Method HST Returns)*

For the year ending December 31, 2019, the Income Statement of Sloan Inc. is as follows (all amounts are without the inclusion of applicable HST):

| | | |
|---|---|---|
| Revenues: | | |
| Sales of Fully Taxable Goods | $291,600 | |
| Provision of Exempt Services | 105,300 | $396,900 |
| Less Expenses: | | |
| Cost Of Goods Sold | ($166,050) | |
| Amortization Expense | ( 75,600) | |
| Salaries And Wages | ( 16,200) | |
| Rent | ( 56,700) | |
| Interest Expense | ( 12,150) | |
| Other Operating Expenses | ( 36,450) | ( 363,150) |
| Income Before Taxes | | $ 33,750 |
| Less: Federal And Provincial Income Taxes | | ( 10,800) |
| Net Income | | $ 22,950 |

**Other Information:**

1. Sloan Inc. is a retail business located in Ontario where all of the Company's revenues and expenses are incurred. The HST rate in Ontario is 13 percent. The quick method rates applicable to the province are 4.4 percent for businesses that purchase goods for resale, and 8.8 percent for service providers.
2. For the previous year ending December 31, 2018, Sloan's cost of goods purchased for resale totaled $148,500 and the revenue from sales of taxable supplies totaled $407,700. Both amounts are before HST.
3. Inventories of taxable goods decreased by $10,800 during the year.
4. All of the Other Operating Expenses involved the acquisition of fully taxable supplies and were acquired to assist in the provision of fully taxable supplies.
5. Of the Salaries And Wages, 52 percent were paid to employees involved in providing exempt services.
6. A capital expenditure was made during the year at an HST inclusive cost of $83,620. The expenditure was for furniture and fixtures that will be used 60 percent for the provision of fully taxable goods. HST was paid on the acquisition of all assets on which amortization is being taken during this period.

**Required**: For the year ending December 31, 2019:

A. Determine if Sloan is eligible to use the Quick Method and the Quick Method remittance rate that would be applicable.

B. Calculate the net HST payable or refund that Sloan Inc. will remit or receive using regular HST calculations.

C. Assume that Sloan is eligible to use the Quick Method. Calculate the net HST payable or refund that Sloan Inc. will remit or receive using the Quick Method.

## Assignment Problem Twenty-One - 9

### (Employee HST Rebate Including CCA)

Sarah Martin is a resident of Ontario, a participating province that assesses HST at a 13 percent rate. Her employer is a large public company with all of its operations in that province.

Sarah's work requires extensive travel on behalf of her employer. For this travel, she uses her own car. The car was purchased in 2018 at a price before HST of $27,500. HST raised the total cost to $31,075 [(113%)($27,500)]. In 2018 she claimed maximum CCA of $4,661 [(1/2)(30%)($31,075)]. The portion of her HST rebate related to her car CCA equaled $536 [(13/113)($4,661)]. Sarah indicates that she plans to claim maximum CCA in 2019.

The family uses her husband's car for all personal purposes so that Sarah's car is used 100 percent for employment related activities. Sarah does not receive any reimbursement or allowance from her employer for her travel or car expenses.

In her 2019 tax return, Sarah deducts the following amounts in the calculation of her net employment income:

| | |
|---|---|
| Accommodation (Includes HST Of $1,560) | $13,560 |
| Business Meals And Entertainment - Deductible Amount | |
| (Includes HST of $1,170) | 10,170 |
| Automobile Costs: | |
| Gas And Maintenance (Includes HST Of $1,430) | 12,430 |
| Interest On Automobile Loan | 1,805 |
| Insurance | 1,460 |
| Total Deductions Excluding CCA | $39,425 |

**Required:** Calculate the maximum CCA that Sarah can claim on his car for 2019. In addition, calculate the 2019 HST rebate that Sarah will claim as a result of her deductible expenses.

## Assignment Problem Twenty-One - 10

### (Regular And Simplified HST Returns)

Adeedas Sports is a retail business located in Nova Scotia. All of its revenues occur and expenses are incurred in that province. It has no associated business and files its GST return on an annual basis. Nova Scotia has a 15 percent HST.

Adeedas's Income Statement for the current year is as follows. All amounts are shown without the relevant HST.

| | | |
|---|---|---|
| Revenues: | | |
| Fully Taxable Goods | $397,523 | |
| Exempt Services | 109,564 | $507,087 |
| Less Expenses: | | |
| Cost Of Goods Sold (All Taxable) | ($201,372) | |
| Amortization Expense | ( 34,784) | |
| Salaries And Wages | ( 25,679) | |
| Rent | ( 27,841) | |
| Interest Expense | ( 75,964) | |
| Other Operating Expenses | ( 31,478) | ( 397,118) |
| Income Before Taxes | | $109,969 |
| Less: Federal And Provincial Income Taxes | | ( 21,489) |
| Net Income | | $ 88,480 |

**Other Information:**

1. Inventories of taxable goods decreased by $19,561 during the year.
2. A capital expenditure was made during the year at an HST inclusive cost of $105,294. The expenditure was for equipment that will be used 60 percent for the provision of fully taxable goods. HST was paid on the acquisition of all assets on which amortization is being taken during this period.
3. All of the Other Operating Expenses involved the acquisition of fully taxable supplies and were acquired to assist in the provision of fully taxable supplies.
4. The rent was not subject to HST as it was paid to a non-registrant. The proportion of the leased property that is used for the provision of exempt services is 20 percent.
5. Of the Salaries And Wages, 40 percent were paid to employees involved in providing exempt services.

**Required:**

A. Calculate the net HST payable or refund that Adeedas Sports will remit or receive for the current year using regular GST calculations.

B. Calculate the net HST payable or refund that Adeedas Sports will remit or receive for the current year using the Simplified Input Tax Credit Method.

## *Assignment Problem Twenty-One - 11*

### *(New Housing GST Rebate)*

All of the following independent Cases involve an individual purchasing a new house in Alberta for a total payment of $200,000. Note that, Alberta does not participate in the HST program and does not have a provincial sales tax.

Varying assumptions are made with respect to what is included in the $200,000 payment.

**Case A** The price includes GST.

**Case B** The price does not include any GST.

**Case C** The price includes GST, net of the new housing rebate.

**Required:** For each Case, determine:

- the pre-rebate amount of GST;
- the amount of the GST rebate that can be claimed;
- who would claim the GST rebate; and
- the net amount of GST that will be paid.

# INDEX



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# NOTES

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# PREFACE

## Complete Preface In Volume I

The complete preface to this three volume set of *Canadian Tax Principles* can be found in Volume I.

## MyLab Accounting

### List Of 2019 Tax Rates And Credits For Your Use

A complete list of 2019 tax rates and credits to use when solving problems is available at the front of both Volumes 1 and 2. This information, as well as the Chapter 5 Appendix of common CCA rates, is available as a .PDF file on MyLab found at:

**http://www.pearsonmylabandmastering.com**

Here you will also find:

- Updates and corrections to the textbook and Study Guide (please check periodically)
- Pearson eText of the complete set - 2 Volumes plus Study Guide
- Self Study Problems (The solutions are in this Study Guide)
- Supplementary Self Study Problems and Solutions for each chapter
- Access to CPA Canada's Federal Income Tax Collection (FITAC)
- Access to Intuit Canada's ProFile tax return preparation software
- Practice Examinations and Solutions for each chapter
- Power Point Presentations for each chapter
- Glossary Flashcards for each chapter
- 2019 tax rates, credits and common CCA Classes (PDF file)
- Tax Returns for examples and Self Study tax return problems
  In January, 2020, shortly after the first 2019 filing version of the ProFile tax program is available, updated sample tax returns and Tax Software Problems will also be available.

## This Study Guide

### Contents

Your two volume textbook is accompanied by this Study Guide. The chapters of this Study Guide correspond to the chapters of ***Byrd & Chen's Canadian Tax Principles***. Each of these Study Guide chapters contains the following:

- Detailed guidance on how to work through the text and problems in the chapter.
- Detailed solutions to the Exercises in the textbook for the chapter and the Self Study Problems available online.
- A list of learning objectives for the material in the chapter.

In addition, there are:

- Two sample personal tax returns and two Self Study Tax Software Problems in Chapters 4 and 11.
- A sample corporate tax return in Chapter 13.

## Glossary

At the back of this Study Guide is a comprehensive Glossary that carefully defines more than 500 tax terms that are used throughout the text. Tied to this important resource, at the end of each chapter you will find a list of the Key Terms, without definitions, that were used in that chapter. This provides an additional resource for reviewing the text material in that, by reviewing this list, you can ensure that you are familiar with all of the concepts that are presented in the chapter.

To assist in this review, Glossary Flashcards for each Chapter are available online.

## Using The Solutions

With respect to the problem solutions that are included in this book, the header at the top of each page identifies the solution on the page. The page numbers in this Study Guide have been numbered with the prefix "S-" to distinguish them from the page numbers of the textbook.

We encourage you to try to solve each Exercise and Self Study Problem before consulting these solutions. It is our opinion that one of the most unfortunate misconceptions that many students have is the belief that simply reading through a solution is a good learning experience. It is not!

June, 2019

Clarence Byrd, Clarence Byrd Inc.
Ida Chen, Clarence Byrd Inc.

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## CHAPTER 21

# CHAPTER 1

## How To Work Through Chapter 1

MyLab Accounting for this book can be found at:

**http://www.pearsonmylabandmastering.com**

We suggest you access MyLab before using the text to familiarize yourself with the useful student resources available there. In particular, review the corrections and updates to the textbook and Study Guide that are posted there to save yourself unnecessary frustration.

We recommend the following approach in dealing with the material in this chapter:

### The Canadian Tax System

- Read paragraph 1-1 to 1-12 (in the textbook).
- Do Exercises One-1 and One-2 (in the textbook) and check the solutions in this Study Guide. All solutions to Exercises and Self Study Problems can be found in this Study Guide and the page numbers all start with the prefix S-.
- Read paragraph 1-13 to 1-17.
- Do Exercise One-3 and check the solution in this Study Guide.
- Read paragraph 1-18 to 1-25.

### Tax Policy Concepts And Qualitative Characteristics Of Tax Systems

- Read paragraph 1-26 to 1-28.
- Do Exercise One-4 and check the solution in this Study Guide.
- Do Self Study Problem One-1 which is available on MyLab and check the solution in this Study Guide.
- Read paragraph 1-29 to 1-34.
- Do Self Study Problem One-2 and check the solution in this Study Guide.
- Read paragraph 1-35 to 1-43.
- Do Self Study Problem One-3 and check the solution in this Study Guide.

### Income Tax Reference Materials

- Read paragraph 1-44 to 1-75.
- Do Self Study Problem One-4 and check the solution in this Study Guide.

### Liability For Income Tax

- Read paragraph 1-76 to 1-93.
- Do Exercise One-5 and check the solution in this Study Guide.

### Residence Of Individuals, Including Part Year, Sojourner, And Deemed Residents

- Read paragraph 1-94 to 1-101.
- Do Exercise One-6 and check the solution in this Study Guide.
- Read paragraph 1-102 to 1-106.
- Do Exercise One-7 and check the solution in this Study Guide.
- Read paragraph 1-107 and 1-108.
- Do Exercises One-8 and One-9 and check the solutions in this Study Guide.
- Read paragraph 1-109 to 1-115.
- Do Exercise One-10 and check the solution in this Study Guide.

### Individuals With Dual Residency

- Read paragraph 1-116 to 1-119.
- Do Exercise One-11 and check the solution in this Study Guide.
- Read paragraph 1-120 to 1-122.
- Do Self Study Problems One-5 to One-7 and check the solutions in this Study Guide.

### Residence Of Corporations And Trusts

- Read paragraph 1-123 to 1-129.
- Do Exercises One-12 to One-14 and check the solutions in this Study Guide.
- Do Self Study Problems One-8 and One-9 and check the solutions in this Study Guide.
- Read paragraph 1-130 to 1-132.

### Alternative Concepts Of Income

- Read paragraph 1-133 to 1-141.

### Net Income For Tax Purposes

- Read paragraph 1-142 to 1-167.
- Do Exercises One-15 to One-17 and check the solutions in this Study Guide.
- Do Self Study Problems One-10 to One-12 and check the solutions in this Study Guide.

### Net Income To Taxable Income

- Read paragraph 1-168 and 1-169.

### Principles Of Tax Planning

- Read paragraph 1-170 to 1-188.
- Do Exercises One-18 and One-19 and check the solutions in this Study Guide.

### Abbreviations To Be Used

- Read paragraph 1-189.

### To Complete This Chapter

- If you would like more practice in problem solving, do the Supplementary Self Study Problems for the chapter. These problems and solutions are available on MyLab.
- Review the Key Terms Used In This Chapter in the textbook at the end of Chapter 1. Consult the Glossary for the meaning of any key terms you do not know.
- Test yourself with the Chapter 1 Glossary Flashcards available on MyLab.
- Ensure you have achieved the Chapter 1 Learning Objectives listed in this Study Guide.
- As a review, we recommend you view the PowerPoint presentation for Chapter 1 that is on MyLab.

### Practice Examination

- Write the Practice Examination for Chapter 1 that is on MyLab. Mark your examination using the Practice Examination Solution that is on MyLab.

# Solutions to Chapter One Exercises

### Exercise One - 1 Solution

Max Jordan, the Jordan family trust, and Jordan Enterprises Ltd. could be required to file income tax returns. Jordan's Hardware, Jordan & Jordan and the Jordan Foundation are not taxable entities for income tax purposes.

### Exercise One - 2 Solution

Under the GST legislation, all of the listed entities could be required to file a GST return. Where only individuals, corporations and trusts can be required to file an income tax return, the definition of a person (i.e., taxable entity) is much broader for GST purposes. As is explained in detail in Chapter 21, whether an entity is required to file a GST return is dependent on the level of commercial activity.

### Exercise One - 3 Solution

| | |
|---|---|
| Federal Tax Payable [(15%)($27,000)] | $4,050 |
| Provincial Tax Payable [(7.5%)($27,000)] | 2,025 |
| Total Tax Payable [(15% + 7.5%)($27,000)] | $6,075 |

### Exercise One - 4 Solution

Margie's HST paid totals $22,360 [(13%)($172,000)]. Based on her Taxable Income of $895,000, this would represent an effective rate of 2.5 percent ($22,360 ÷ $895,000).

Jane's HST paid totals $3,575 [(13%)($27,500)]. On her Taxable Income of $18,000, this would be an effective rate of 19.9 percent ($3,575 ÷ $18,000).

### Exercise One - 5 Solution

She is not correct. Under ITA 2(3) she would be subject to Canadian taxes on employment income earned in Canada.

### Exercise One - 6 Solution

While the situation is not completely clear, it is likely that the CRA would conclude that Simon is no longer a Canadian resident. By retaining his residence, he has maintained one of the primary residential ties. However, the fact that he was not able to sell the property, accompanied by the long-term lease to a third party would probably be sufficient evidence that this is not a significant residential tie. The retention of his membership in the Ontario Institute Of Chartered Public Accountants would be viewed as a secondary residential tie. However, S5-F1-C1 indicates that it would be unusual for a single secondary tie to be sufficient for an individual to be considered a Canadian resident.

### Exercise One - 7 Solution

Jane did, in fact, sever most of her residential ties with Canada. This would suggest that she would not be considered a Canadian resident during the 26 months that she worked in Florida. However, the fact that she returned frequently to visit her boyfriend might lead the CRA to assess her on the basis of being a Canadian resident during this period, but it is not clear that such an assessment would be successful.

### Exercise One - 8 Solution

Mark would be taxed on his worldwide income for the part of the year that he was resident in Canada. This would be the period January 1 through June 15, the date that his wife and children fly to the U.S. June 15 would be latest of the date that Mark leaves Canada (February 1), the date that Mark establishes U.S. residency (February 1), and the date that his wife and children depart Canada (June 15). It is unlikely that the fact that his house was not sold until a later date would influence his residence status.

### Exercise One - 9 Solution

Mr. Kirsh will be a part year resident and liable for Canadian taxes on his worldwide income, including any income on the U.S. bank accounts, for the period September 1 through December 31 of the current year.

### Exercise One - 10 Solution

While Ms. Blakey is the child of a Canadian High Commissioner, it appears that she is no longer a dependant of this individual. It would also appear that she has income in excess of the base for the basic personal tax credit for 2019 of $12,069. As a consequence, she would not be considered a deemed resident under ITA 250(1).

### Exercise One - 11 Solution

**Case 1** As it appears that Dizzy has a permanent home in Los Angeles, the tie-breaker rules would indicate that he is a resident of the United States. As he has been in Canada for more than 183 days in 2019, the sojourner rules might have made him a deemed Canadian resident. However, the tie-breaker rules in the international tax treaty would override this.

The boarding rooms and hotels would not be considered to be a permanent home given that Dizzy never intended to stay for a long period of time.

**Case 2** As Donna was in Canada for more than 183 days in 2019, she is a deemed resident through the application of the sojourner rule, and therefore a dual resident. In applying the tie-breaker rules, the first factor that is considered is in which country the individual has a permanent home. With respect to this criteria, Donna would not be considered to have a permanent home in either country. She gave up her lease on the New York property and, given that she only planned to stay for a short period of time, the Toronto apartment would not be considered a permanent home. In the absence of a permanent home in either country, the next factor to consider would be the location of Donna's "centre of vital interests". This would appear to be the U.S. and, given this, the tie-breaker rules would make Donna a resident of the U.S. and a non-resident of Canada.

### Exercise One - 12 Solution

Roswell Ltd. is a U.S. resident because it was incorporated in that country. It is also a Canadian resident under the mind and management test. In such dual residency cases, the tie-breaker rule in the Canada/U.S. tax treaty indicates that the taxes will be assessed in the country of incorporation. That means that Roswell Ltd. would be considered a resident of the U.S. and a non-resident of Canada.

### Exercise One - 13 Solution

As the Company was incorporated in Canada after April 26, 1965, it would be deemed to be a Canadian resident under ITA 250(4). While the problem does not provide enough information to determine this, it is possible that the Company has dual residency with the country or countries where it does business. This could result in the application of one or more international tax treaties. Note that, in general, where a corporation does business is not relevant to the residency decision.

### Exercise One - 14 Solution

**Case 1** Taxco would be considered a deemed resident of Canada by ITA 250(4) since it was incorporated in Canada after April 26, 1965. Taxco would also be considered a factual resident of the U.S. since its mind and management are located there. Article IV(3) of the Canada/U.S. tax treaty however breaks the tie in favor of the place of incorporation. Taxco would therefore be considered a resident of Canada and a non-resident of the U.S.

**Case 2** Junko would be considered a factual resident of Canada since its mind and management are situated in Canada. Junko would also be considered a resident of the U.S. since it was incorporated there. Article IV(3) of the Canada/U.S. tax treaty however breaks the tie in

favor of the place of incorporation. Junko would therefore be considered a resident of the U.S. for treaty purposes and a non-resident of Canada.

### Exercise One - 15 Solution

Mr. Blanton's Net Income For Tax Purposes is calculated as follows:

| | | |
|---|---|---|
| **Income Under ITA 3(a):** | | |
| Net Employment Income | | $42,000 |
| **Income Under ITA 3(b):** | | |
| Taxable Capital Gains | $24,000 | |
| Allowable Capital Losses | Nil | 24,000 |
| **Balance From ITA 3(a) And (b)** | | $66,000 |
| Subdivision e Deductions | | ( 13,000) |
| **Balance Under ITA 3(c)** | | $53,000 |
| Deduction Under ITA 3(d): | | |
| Business Loss | | ( 15,000) |
| **Net Income For Tax Purposes (Division B Income)** | | **$38,000** |

### Exercise One - 16 Solution

Ms. Stodard's Net Income For Tax Purposes would be calculated as follows:

| | | |
|---|---|---|
| **Income Under ITA 3(a):** | | |
| Interest Income | | $33,240 |
| **Income Under ITA 3(b):** | | |
| Taxable Capital Gains | $24,750 | |
| Allowable Capital Losses | ( 19,500) | 5,250 |
| **Balance From ITA 3(a) And (b)** | | $38,490 |
| Subdivision e Deductions | | Nil |
| **Balance Under ITA 3(c)** | | $38,490 |
| Deduction Under ITA 3(d): | | |
| Rental Loss | | ( 48,970) |
| **Net Income For Tax Purposes (Division B Income)** | | **Nil** |

She would have a non-capital loss carry over of $10,480 ($38,490 - $48,970).

### Exercise One - 17 Solution

Mrs. Bergeron's Net Income For Tax Purposes would be calculated as follows:

| | | |
|---|---|---|
| **Income Under ITA 3(a):** | | |
| Net Employment Income | | $42,680 |
| **Income Under ITA 3(b):** | | |
| Taxable Capital Gains | $27,400 | |
| Allowable Capital Losses | ( 33,280) | Nil |
| **Balance From ITA 3(a) And (b)** | | $42,680 |
| Subdivision e Deductions | | ( 8,460) |
| **Balance Under ITA 3(c)** | | $34,220 |
| Deduction Under ITA 3(d): | | |
| Business Loss | | ( 26,326) |
| **Net Income For Tax Purposes (Division B Income)** | | **$ 7,894** |

She would have an allowable capital loss carry over of $5,880 ($27,400 - $33,280).

***Exercise One - 18 Solution***

Mr. Chung is involved in income splitting, tax deferral, and possibly tax avoidance. He is getting the deduction from taxable income now and his wife will be taxed on the income in the future. All RRSP contributions normally create a tax deferral. The contribution will be deductible and the earnings on the contribution will accumulate on a tax free basis. However, all of these amounts will be taxable when they are withdrawn from the plan. There may also be tax avoidance. This will happen if his spouse is taxed at a lower rate than is currently applicable to Mr. Chung when the funds become taxable to her.

***Exercise One - 19 Solution***

As the dental plan is a benefit that can be received by Mr. Green without being taxed (private health care), tax avoidance is illustrated.

## Self Study Solution One - 1

The HST is based on certain specified expenditures, not on the income level of the individual making the expenditure. In most cases, the proportion of an individual's income that is spent declines as the individual's level of income increases. This means that when a flat rate of tax is applied to a decreasing portion of the individual's income, the rate of taxation as a percentage of that income will decline.

For example, a 13 percent HST applied to $150,000 in expenditures made by a person with $250,000 in income would amount to only 7.8 percent of that person's income ($19,500 ÷ $250,000).

In contrast, that same 13 percent HST applied to $25,000 in expenditures made by a person with $20,000 in income would reflect a tax rate of 16.3 percent ($3,250 ÷ $20,000) of that person's income.

## Self Study Solution One - 2

If tax simplification was the only objective, Mr. Right's proposal would be appropriate. However, such a system would be in conflict with other possible objectives of tax policy. For example, it would almost certainly be in conflict with the objective of fairness in that it would not provide for treating different types of income (capital gains vs. employment income) or people (the poor vs. the rich) in a suitable manner.

His system would also conflict with other objectives such as the goal of equity and after-tax income stability and the need for redistribution of income. In other words, in meeting the objective of simplicity, Mr. Right's system would ignore other possible objectives of a taxation system.

## Self Study Solution One - 3

> **Note** The descriptions of these tax measures are significantly simplified. The objective of this problem is to present the basic ideas so they can be understood without a detailed knowledge of tax, while still providing a basis for discussion. The following analysis is intended to be no more than suggestive of possible points that could be made. There are, of course, many alternative solutions.

***Family Tax Cut***

Possible comments here would be as follows:

**Equity Or Fairness** This provision was heavily criticized for providing most of its benefits to high income individuals. The tax cost of this provision was estimated to be $2.4 billion, very little of which was available to low income families and none to single parent families. Its repeal in 2016 was due in large part to its lack of fairness.

**Simplicity** This was an extremely complex provision that few individuals, other than tax professionals, fully understood. Evidence of this: The government did not get the initial legislation right and was forced to issue revisions.

### *Increase In Lifetime Capital Gains Deduction*

Possible comments here would be as follows:

**Neutrality** The increase in the amount of the deduction for farmers and fishermen is not neutral. It favours farmers and fishermen with no benefits for any other group.

**Simplicity** The determination of what properties are considered to be qualified for this deduction involves some very complex legislation.

### *Home Accessibility Tax Credit*

Possible comments here would be as follows:

**Neutrality** This provision is not neutral. Its benefits accrue exclusively to seniors, disabled individuals, and their families. Other individuals do not benefit from this provision.

**Equity Or Fairness** Disabled seniors face accessibility challenges that are not present for most other individuals. Given this, it can be argued that helping this particular group involves fairer treatment of these individuals.

### *Reduction In Small Business Rate*

Possible comments here would be as follows:

**International Competitiveness** It is likely that this tax cut will make Canada a more attractive environment for small business.

**Certainty** By announcing the decrease in advance, certainty of the future rate was provided.

### *Increase In Tax Free Savings Account Limits*

Possible comments here would be as follows:

**Equity Or Fairness** It was clear that this change would not benefit low income individuals. If an individual is making $20,000 per year, it is highly unlikely that this individual would have the first $5,500, much less an extra $4,500 to contribute. The reversal of the increase in 2016 was due in large part to its lack of fairness.

**Simplicity** This change gets high marks for simplicity. Amounts earned on the assets in the account are not subject to tax, either while the assets are in the plan or when the earnings are removed from the plan.

## Self Study Solution One - 4

The principal other sources of information can be described as follows:

1. **Draft Legislation** This legislation often provides the only information available with respect to announced budget changes that require application in the current taxation year. Explanatory notes are included with released draft legislation but are always set out separately.

2. **Income Tax Regulations** These Regulations provide detailed guidance with respect to the implementation and administrative enforcement of the provisions of the *Income Tax Act*.

3. **International Tax Treaties** These are a group of bilateral tax treaties between Canada and other countries. They are designed to avoid double taxation of taxpayers who pay taxes in more than one jurisdiction and to prevent international tax evasion.

4. **Income Tax Folios** Income Tax Folios are a new series of publications introduced in 2013 that deal with technical issues. The publications are organized into seven Series with each Series divided into Folios that contain Chapters on specific topics. As new Folios are introduced, the Interpretation Bulletins and Income Tax Technical Newsletters they are replacing are being cancelled.

5. **Interpretation Bulletins** These IT-Bulletins give the CRA's interpretations of particular sections of the law which it administers and provide a vehicle for announcing significant changes in departmental interpretation. These Bulletins are being replaced over the next few years by the new series, Income Tax Folios (see item 4).

6. **Income Tax Application Rules, 1971 (ITARs)** These are a set of transitional rules that were introduced when the *Income Tax Act* was heavily revised at the end of 1971. The rules were largely designed to ensure that the provisions of the new *Act* were not applied retroactively. Although they continue to be of some significance in a limited number of situations, their general importance has been greatly diminished over time.

7. **Income Tax Technical News** These newsletters were an occasional publication of the CRA which provided detailed guidance on various current issues. Existing newsletters are being cancelled as new Income Tax Folios (see item 6) are gradually incorporating their content.

8. **Information Circulars** These Circulars provide information with respect to procedural matters related to both the *Income Tax Act* and the Canada Pension Plan.

9. **CRA News Releases, Tax Tips and Fact Sheets** The CRA provides News Releases, tax tips and fact sheets on a variety of current subjects on its website.

10. **Guides And Pamphlets** These non-technical publications provide guidance for the public on a variety of income tax issues (e.g., treatment of rental income).

11. **Advance Income Tax Rulings** For a fee, the CRA will provide an Advance Income Tax Ruling on how it will tax a proposed transaction, subject to certain limitations and qualifications. These are rulings that are provided in response to requests from taxpayers.

12. **Technical Interpretations** The CRA provides both written and telephone Technical Interpretations to the public free of charge. These Interpretations provide technical information on various current issues.

13. **Court Decisions** Decisions by the Tax Court of Canada, the Federal Court and the Supreme Court on income tax cases serve to establish precedents for dealing with particular tax issues.

## Self Study Solution One - 5

S5-F1-C1 indicates that, in general, the CRA will view an individual as becoming a non-resident on the latest of three dates:

- The date the individual leaves Canada.
- The date the individual's spouse or common-law partner and dependants leave Canada.
- The date the individual becomes a resident of another country.

As Paul's wife and daughter did not leave Canada, it would appear that the CRA would take the position that Paul did not stop being a resident of Canada.

As he purchased a house in the U.S., it is possible that he will also be viewed as a resident of that jurisdiction. If this is the case, the tie breaker rules that are contained in the tax treaty between Canada and the U.S. tax treaty must be applied. As Paul has a permanent home available in both locations, we need to apply the center of vital interests criterion. The personal ties appear to be stronger in Canada, so it is likely that the CRA would conclude that the center of vital interests is Canada. Given this, Paul would not be considered to be resident in the U.S.

Based on this conclusion, Paul should report his worldwide income in Canada, and claim a foreign tax credit for any U.S. tax paid on his employment income while he was living and working in the U.S.

## Self Study Solution One - 6

### *Mr. Aiken And Mr. Baker*

Assuming that their respective moves were permanent in nature, both Mr. Aiken and Mr. Baker would be treated as part year residents. This means that they would be considered residents of Canada only for that portion of the year that they were actually in Canada. As a result, they will be liable for Canadian taxes only for a part of the current year. The prorating of deductions and credits are determined in accordance with ITA 114 and ITA 118.91.

### *Mr. Chase*

While Mr. Chase was in Canada for the same number of days as the other individuals, the fact that he was present only on a temporary basis makes him subject to the sojourning rule. Under this rule [see ITA 250(1)(a)], he will be considered a resident for the full year if he sojourns in Canada for 183 days or more during any calendar year. As Mr. Chase was present for 192 days, he would be viewed as a Canadian resident throughout the year.

However, as he appears to also be a resident of the U.S., his dual residency status would be resolved by the tie-breaker rules in the Canada/U.S. tax treaty. As he only has a permanent home in the U.S., the tie breaker rules would deem Mr. Chase not to be a resident of Canada. This means that he would be taxed in the U.S.

## Self Study Solution One - 7

A. Jane Smith would be deemed a Canadian resident because she is a dependent child of a Canadian ambassador [ITA 250(1)(f)].

B. Marvin Black would not be considered a resident of Canada as he does not live in Canada. He would not be a deemed resident as S5-F1-C1 makes it clear that days spent commuting to Canada to earn employment income do not count as sojourning in Canada. However, he would likely be subject to Canadian taxation on the employment income earned in Canada [ITA 2(3)(a)].

C. John Leather would be considered a resident of Canada for the part of the year until September 12. As his presence in Canada during the first part of the year was not on a part time basis, he would not fall under the sojourning rules.

D. Members of the Canadian armed forces are deemed to be Canadian residents without regard to where they actually live. As Francine Donaire is exempt from French taxation due to her relationship to a deemed resident, she is a deemed resident of Canada [ITA 250(1)(g)].

E. More information would be required here. Depending on the nature of his stay in Canada, Robert could either be a part year resident of Canada or, alternatively, a non-resident earning employment income in Canada. If he established sufficient residential ties in Canada, it is possible that he would be viewed as a resident during his short stay.

The importance of this is that, under this interpretation of the facts, he would be subject to Canadian income tax on his worldwide income during his stay. Alternatively, if he is not considered a resident during his stay in Canada, he is likely to be subject to Canadian tax on only his Canadian employment income.

F. The fact that Susan Allen is a Canadian citizen is irrelevant to the determination of residency. Since she appears to have no residential ties with Canada, she would not be considered a Canadian resident.

## Self Study Solution One - 8

A. As AMT Ltd. was incorporated prior to April 27, 1965, it is not automatically considered to be a resident of Canada. However, under Canadian legislation the Company would be deemed a Canadian resident based on the fact that the mind and management was in Canada subsequent to that date. [ITA 250(4)(a) and (c)].

As the mind and management is now in the U.S., it would also be considered a U.S. resident. Given this dual residency, the tie-breaker rules in the Canada/U.S. Tax Treaty resolve the situation by making the Company a resident of its country of incorporation. This would result in AMT being considered a resident of Canada.

B. UIF Inc. was not incorporated in Canada and its mind and management are not currently within Canada. Therefore, UIF Inc. would not be considered a Canadian resident.

C. BDT Ltd. would be deemed a Canadian resident. This is because it was incorporated in Canada subsequent to April 26, 1965. [ITA 250(4)(a)]. However, as the mind and management is now in the U.S., it would also be considered a U.S. resident. Given this dual residency, the tie-breaker rules in the Canada/U.S. Tax Treaty resolve the situation by making the Company a resident of its country of incorporation. This would result in BDT being considered a resident of Canada.

D. While QRS Inc. was not incorporated in Canada, it would appear that its mind and management are located in Ontario. However, as it was incorporated in New York state, it will also be considered a resident of the U.S. As noted previously, in such cases, the tie-breaker rules in the Canada/U.S. Tax Treaty would make the Company a resident of the U.S. as that is the country of incorporation and not a Canadian resident.

## Self Study Solution One - 9

### *Case A*

Mr. Salazar is not a resident of Canada. Commuting across the border for employment purposes is not considered sojourning (S5-F1-C1). However, unless he is exempted by the Canada/U.S. tax treaty, he would be subject to Canadian taxation on the employment income which he earns in Windsor.

With respect to the treaty exemption, his employment income exceeds $10,000 and he is physically present in Canada for more than 183 days in the year. Given these facts, he would not qualify for the treaty exemption.

### *Case B*

The information suggests that Mr. Wills made a clean break with Canada on September 1 of the current year. As a consequence, he would be considered a Canadian resident for the portion of the current year prior to his departure and would be taxed on his worldwide income for this period. For the portion of the year subsequent to his departure, he would no longer be considered a Canadian resident.

***Case C***

Joan Brothers would be deemed to be a Canadian resident under ITA 250(1)(f) because she is a dependent child of an officer or servant of Canada who is deemed to be a resident of Canada under ITA 250(1)(c)(i).

***Case D***

Brogan Inc. was not incorporated in Canada and its mind and management are not currently within Canada. As a result, the Company is not a Canadian resident and none of its income would be subject to Canadian taxes.

***Case E***

Mercer Ltd. was incorporated prior to April 27, 1965 and, if it had not resided in or done business in Canada subsequent to that date, it would not be considered a resident of Canada. However, the fact that directors meetings were held in Canada until May, 1996 makes it a Canadian resident. As the mind and management are now in the U.S., it would also be considered a resident of that country.

In cases of dual residency for corporations, where a corporation could be considered a resident of both countries, the Canada/U.S. tax treaty indicates that the corporation will be deemed to be a resident only in the country in which it is incorporated. Mercer Ltd. would be a resident of Canada and its worldwide income would be subject to tax in Canada.

***Case F***

The Booker Manufacturing Company would be considered resident in Canada because of the location of its mind and management. However, as Booker was incorporated in the U.S., it would also be considered a resident of that country. In cases of dual residency for corporations, where a corporation could be considered a resident of both countries, the Canada/U.S. tax treaty indicates that the corporation will be deemed to be a resident only in the country in which it is incorporated. As a result, the Company is not a Canadian resident and none of its income would be subject to Canadian taxes.

## Self Study Solution One - 10

***Case A***

The Case A solution would be calculated as follows:

| | | |
|---|---|---|
| Income Under ITA 3(a): | | |
| Employment Income | $50,000 | |
| Interest Income | 12,000 | $62,000 |
| Income Under ITA 3(b): | | |
| Taxable Capital Gains | $95,000 | |
| Allowable Capital Losses | ( 73,000) | 22,000 |
| Balance From ITA 3(a) And (b) | | $84,000 |
| Subdivision e Deductions | | ( 8,000) |
| Balance From ITA 3(c) | | $76,000 |
| Deductions Under ITA 3(d): | | |
| Business Loss | | ( 23,000) |
| Net Rental Loss | | ( 5,000) |
| Net Income For Tax Purposes (Division B Income) | | $48,000 |

In this Case, Mr. Dorne has no carry overs available.

***Case B***

The Case B solution would be calculated as follows:

| | | |
|---|---|---|
| Income Under ITA 3(a): | | |
| Employment Income | $45,000 | |
| Net Rental Income | 23,000 | $68,000 |
| Income Under ITA 3(b): | | |
| Taxable Capital Gains | $25,000 | |
| Allowable Capital Losses | ( 46,000) | Nil |
| Balance From ITA 3(a) And (b) | | $68,000 |
| Subdivision e Deductions | | ( 10,500) |
| Balance From ITA 3(c) | | $57,500 |
| Deduction Under ITA 3(d): | | |
| Business Loss | | ( 51,000) |
| Net Income For Tax Purposes (Division B Income) | | $ 6,500 |

In this Case, Mr. Dorne has a carry over of unused allowable capital losses in the amount of $21,000 ($46,000 - $25,000). The lottery prize is not considered to be income for tax purposes.

## Self Study Solution One - 11

***Case A***

The Case A solution would be calculated as follows:

| | | |
|---|---|---|
| Income Under ITA 3(a): | | |
| Employment Income | $73,300 | |
| Rental Income | 8,300 | $81,600 |
| Income Under ITA 3(b): | | |
| Taxable Capital Gains | $42,400 | |
| Allowable Capital Losses | ( 18,600) | 23,800 |
| Balance From ITA 3(a) And (b) | | $105,400 |
| Subdivision e Deductions | | ( 6,200) |
| Balance From ITA 3(c) | | $ 99,200 |
| Deduction Under ITA 3(d): | | |
| Business Loss | | ( 14,700) |
| Net Income For Tax Purposes (Division B Income) | | $ 84,500 |

In this Case, Mr. Marks has no loss carry overs at the end of the year.

***Case B***

The Case B solution would be calculated as follows:

| | | |
|---|---|---|
| Income Under ITA 3(a): | | |
| Employment Income | $41,400 | |
| Rental Income | 5,900 | $ 47,300 |
| Income Under ITA 3(b): | | |
| Taxable Capital Gains | $ 7,800 | |
| Allowable Capital Losses | ( 11,600) | Nil |
| Balance From ITA 3(a) And (b) | | $47,300 |
| Subdivision e Deductions | | ( 2,800) |
| Balance From ITA 3(c) | | $44,500 |
| Deduction Under ITA 3(d): | | |
| Business Loss | | ( 4,700) |
| Net Income For Tax Purposes (Division B Income) | | $39,800 |

In this Case, Mr. Marks has an allowable capital loss carry over of $3,800 ($7,800 - $11,600).

***Case C***

The Case C solution would be calculated as follows:

| | | |
|---|---|---|
| Income Under ITA 3(a): | | |
| Employment Income | $89,400 | |
| Rental Income | 5,300 | $94,700 |
| Income Under ITA 3(b): | | |
| Taxable Capital Gains | $23,700 | |
| Allowable Capital Losses | ( 21,200) | 2,500 |
| Balance From ITA 3(a) and (b) | | $97,200 |
| Subdivision e Deductions | | ( 22,400) |
| Balance From ITA 3(c) | | $74,800 |
| Deduction Under ITA 3(d): | | |
| Business Loss | | ( 112,600) |
| Net Income For Tax Purposes (Division B Income) | | Nil |

In this Case, Mr. Marks would have a business loss carry over in the amount of $37,800 ($74,800 - $112,600).

***Case D***

The Case D solution would be calculated as follows:

| | | |
|---|---|---|
| Income Under ITA 3(a): | | |
| Employment Income | | $34,300 |
| Income Under ITA 3(b): | | |
| Taxable Capital Gains | $24,700 | |
| Allowable Capital Losses | ( 26,300) | Nil |
| Balance From ITA 3(a) And (b) | | $34,300 |
| Subdivision e Deductions | | ( 6,400) |
| Balance From ITA 3(c) | | $27,900 |
| Deduction Under ITA 3(d): | | |
| Business Loss | | ( 47,800) |
| Rental Loss | | ( 20,100) |
| Net Income For Tax Purposes (Division B Income) | | Nil |

Mr. Marks would have a carry over of business and rental losses in the amount of $40,000 ($27,900 - $47,800 - $20,100) and of allowable capital losses in the amount of $1,600 ($24,700 - $26,300).

## Self Study Solution One - 12

### *Case 1*

The Case 1 solution would be calculated as follows:

| | | |
|---|---|---|
| Income Under ITA 3(a): | | |
| Net Employment Income | $123,480 | |
| Interest Income | 4,622 | $128,102 |
| Income Under ITA 3(b): | | |
| Taxable Capital Gains | $24,246 | |
| Allowable Capital Losses | ( 4,835) | 19,411 |
| Balance From ITA 3(a) And (b) | | $147,513 |
| Child Care Costs | | ( 9,372) |
| Balance From ITA 3(c) And Net Income For Tax Purposes | | $138,141 |

In this Case, Mr. Comfort has no loss carry overs at the end of the year.

### *Case 2*

The Case 2 solution would be calculated as follows:

| | | |
|---|---|---|
| Income Under ITA 3(a): | | |
| Net Business Income | | $72,438 |
| Income Under ITA 3(b): | | |
| Taxable Capital Gains | $4,233 | |
| Allowable Capital Loss | ( 7,489) | Nil |
| Balance From ITA 3(a) And (b) | | $72,438 |
| RRSP Contributions | | ( 22,000) |
| Balance From ITA 3(c) | | $50,438 |
| Deduction Under ITA 3(d): | | |
| Net Rental Loss | | ( 9,846) |
| Net Income For Tax Purposes (Division B Income) | | $40,592 |

In this Case, Mr. Comfort has a carry over of $3,256 ($7,489 - $4,233) in unused allowable capital losses.

### *Case 3*

The Case 3 solution would be calculated as follows:

| | | |
|---|---|---|
| Income Under ITA 3(a): | | |
| Net Employment Income | | $47,234 |
| Income Under ITA 3(b): | | |
| Taxable Capital Gains [(1/2)($12,472)] | $6,236 | |
| Allowable Capital Losses [(1/2)($9,332)] | ( 4,666) | 1,570 |
| Balance From ITA 3(a) and (b) | | $48,804 |
| Child Care Costs | | ( 3,922) |
| Balance From ITA 3(c) | | $44,882 |
| Deduction Under ITA 3(d): | | |
| Net Business Loss | | ( 68,672) |
| Net Income For Tax Purposes (Division B Income) | | Nil |

In this Case, Mr. Comfort would have a business loss carry over in the amount of $23,790 ($68,672 - $44,882).

***Case 4***

The Case 4 solution would be calculated as follows:

| | | |
|---|---|---|
| Income Under ITA 3(a): | | |
| Interest Income | $ 6,250 | |
| Net Business Income | 43,962 | $50,212 |
| Income Under ITA 3(b): | | |
| Taxable Capital Gains [(1/2)($12,376)] | $ 6,188 | |
| Allowable Capital Losses [(1/2)($23,874)] | ( 11,937) | Nil |
| Balance From ITA 3(a) And (b) | | $50,212 |
| Moving Expenses | | ( 7,387) |
| Balance From ITA 3(c) | | $42,825 |
| Deduction Under ITA 3(d): | | |
| Net Rental Loss | | ( 72,460) |
| Net Income For Tax Purposes (Division B Income) | | Nil |

Mr. Comfort would have a rental loss carry over in the amount of $29,635 ($72,460 - $42,825) and unused allowable capital losses in the amount of $5,749 ($11,937 - $6,188).

## Chapter 1 Learning Objectives

After completing Chapter 1, you should be able to:

1. List some of the different bases that can be used by the various levels of government to assess taxes (paragraph [P hereafter] 1-1 through 1-6).
2. List all of the types of entities that are subject to paying federal income taxes and GST (P 1-7 through 1-12).
3. Explain the relationship between the assessment of taxes at the federal level and the assessment of taxes at the provincial level (P 1-13 through 1-25).
4. List some of the ways that taxation is used to achieve economic objectives (P 1-26).
5. Describe the differences between progressive, regressive, and flat tax systems, including some of the advantages and disadvantages of each system (P 1-27 through 1-34).

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6. Discuss the issue of who ultimately pays the cost of various types of taxes (P 1-35 and 1-36).
7. Explain the nature of tax expenditures (P 1-37 through 1-40).
8. Evaluate issues in tax policy on the basis of the qualitative characteristics of tax systems (P 1-41 through 1-43).
9. Describe the reference materials that are available on income tax databases (P 1-44 through 1-48).
10. Describe the general structure of the *Income Tax Act* (P 1-49 through 1-60).

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11. List and explain the nature of other sources of income tax legislation (P 1-61 through 1-70).
12. Describe other sources of income tax information (P 1-71 through 1-75).
13. Describe the charging provisions of the *Income Tax Act* for residents and non-residents (P 1-76 through 1-93).
14. Determine the residence of an individual based on an evaluation of primary and secondary residential ties (P 1-94 through 1-101).
15. Evaluate the residency status of an individual who is temporarily absent from Canada or is only resident for part of the year (P 1-102 through 1-108).

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16. Identify the types of individuals who will be deemed to be Canadian residents without regard to their actual physical location (P 1-109 through 1-122).
17. Determine the residence of corporations and trusts (P 1-123 through 1-132).
18. Describe, in general terms, the various views of income that are held by economists, accountants, and tax authorities (P 1-133 through 1-141).
19. Calculate Net Income For Tax Purposes by applying the rules found in Section 3 of the *Income Tax Act* (P 1-142 through 1-167).
20. Explain how Net Income For Tax Purposes is converted to Taxable Income (P 1-168 and 1-169).

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21. Explain the principles of tax planning (P 1-170 through 1-173).
22. Explain and provide examples of tax avoidance or reduction, and tax deferral (P 1-174 through 1-181).
23. Explain and provide examples of income splitting (P 1-182 through 1-188).

# CHAPTER 2

## How To Work Through Chapter 2

We recommend the following approach in dealing with the material in this chapter:

**Administration Of The Department**

- Read paragraph 2-1 to 2-7 (in the textbook).

**Filing Requirements For Living And Deceased Individuals**

- Read paragraph 2-8 to 2-17.
- Do Exercise Two-1 (in the textbook) and check the solution in this Study Guide.
- Read paragraph 2-18 to 2-20.
- Do Exercise Two-2 and check the solution in this Study Guide.

**Withholdings For Income Tax**

- Read paragraph 2-21 to 2-27.

**Instalment Payments For Individuals**

- Read paragraph 2-28 to 2-43.
- Do Exercises Two-3 to Two-5 and check the solutions in this Study Guide.
- Do Self Study Problem Two-1 which is available on MyLab and check the solution in this Study Guide.

**Interest, Penalties And Balance Due Dates For Living And Deceased Individuals**

- Read paragraph 2-44 to 2-55.
- Do Exercise Two-6 and check the solution in this Study Guide.
- Read paragraph 2-56 to 2-60.

**Returns And Payments, Including Instalments, For Corporations**

- Read paragraph 2-61 to 2-73.
- Do Exercises Two-7 and Two-8 and check the solutions in this Study Guide.

**Balance Due Dates For Corporations**

- Read paragraph 2-74 and 2-75.
- Do Exercise Two-9 and check the solution in this Study Guide.

**Interest And Penalties For Corporations**

- Read paragraph 2-76 to 2-79.
- Do Self Study Problems Two-2 to Two-4 and check the solutions in this Study Guide.

**Returns And Payments For Trusts**

- Read paragraph 2-80 to 2-87.
- Do Self Study Problem Two-5 and check the solution in this Study Guide.

### General Administrative Issues, Including The "My Account" Service, Assessments, Refunds, And Adjustments To Returns

- Read paragraph 2-88 to 2-104.

### Appeals And Notices Of Objection

- Read paragraph 2-105 to 2-120.
- Do Exercise Two-10 and check the solution in this Study Guide.
- Read paragraph 2-121 to 2-130.
- Do Self Study Problem Two-6 and check the solution in this Study Guide.

### Tax Evasion, Avoidance, And Planning

- Read paragraph 2-131 to 2-140.

### Collection And Enforcement

- Read paragraph 2-141 to 2-152.
- Do Self Study Problem Two-7 and check the solution in this Study Guide.

### Taxpayer Relief Provisions

- Read paragraph 2-153 to 2-156.

### To Complete This Chapter

- If you would like more practice in problem solving, do the Supplementary Self Study Problems for the chapter. These problems and solutions are available on MyLab.
- Review the Key Terms Used In This Chapter in the textbook at the end of Chapter 2. Consult the Glossary for the meaning of any key terms you do not know.
- Test yourself with the Chapter 2 Glossary Flashcards available on MyLab.
- Ensure you have achieved the Chapter 2 Learning Objectives listed in this Study Guide.
- As a review, we recommend you view the PowerPoint presentation for Chapter 2 that is on MyLab.

### Practice Examination

- Write the Practice Examination for Chapter 2 that is on MyLab. Mark your examination using the Practice Examination Solution that is also on MyLab.

## Solutions to Chapter Two Exercises

### Exercise Two - 1 Solution

While Mr. Katarski's 2019 tax return does not have to be filed until June 15, 2020, his tax liability must be paid by April 30, 2020 in order to avoid the assessment of interest.

### Exercise Two - 2 Solution

Sally Cheung's 2019 tax return must be filed by the later of six months after the date of her death and her normal filing date. As her husband has business income, her normal filing date is June 15, 2020. The later of the two dates would be August 15, 2020, six months after the date of her death. Her final return for 2020 would be due on June 15, 2021.

### Exercise Two - 3 Solution

She is not required to make instalment payments as long as her current year (2019) net tax owing is less than $3,000.

### Exercise Two - 4 Solution

As his net tax owing in the current year and one of the two preceding years is in excess of $3,000, he is required to make instalment payments. The minimum amount would be based on the preceding taxation year's net tax owing of $1,500, and would be $375 ($1,500 ÷ 4) per quarter. They are due on March 15, June 15, September 15, and December 15.

### Exercise Two - 5 Solution

The net tax owing amounts can be calculated as follows:

**2017** $1,000 ($53,000 - $52,000)
**2018** $7,000 ($59,000 - $52,000)
**2019** $4,000 ($64,000 - $60,000)

As the net tax owing exceeds $3,000 in the current year and the first preceding year, instalments are required. The three alternatives for calculating instalment payments are as follows:

- Based on the estimate for the current year, the instalments would be $1,000 ($4,000 ÷ 4).
- Based on the estimate for the preceding year, the instalments would be $1,750 ($7,000 ÷ 4).
- Based on the second preceding year, the first two instalments would each be $250 ($1,000 ÷ 4). The second two instalments would each be $3,250 {[1/2][$7,000 - ($250)(2)]}. The instalments would total $7,000, the same amount as under the preceding year alternative.

While the first two instalments are lower under the second preceding year alternative, the total for all the instalments under this alternative is $7,000, higher than the $4,000 total under the current year alternative. The current year alternative would be the best. They are due on March 15, June 15, September 15, and December 15. Note, however, that if the estimated taxes payable are below actual taxes payable for 2019, instalment interest may be charged.

### Exercise Two - 6 Solution

Given the size of her net tax owing, ITA 163.1 will not be applicable and there will be no penalties for late instalments. The penalty for late filing will be based on the number of **complete** months of non-payment, which is two. It will be equal to 7 percent of taxes payable (5 percent, plus 1 percent per month). If, in one of the three preceding taxation years she has also late filed, the penalty could be 14 percent (10 percent, plus 2 percent per month) if the CRA has already sent a request for the return.

Interest will be assessed on the deficient instalments, calculated from the date on which the instalment was due. Interest will also be assessed on the balance owing on her filing date, along with the penalty for late filing. This interest will be assessed for the period May 1 through July 20, 2020. All of the interest will be calculated at the prescribed rate plus 4 percent.

### *Exercise Two - 7 Solution*

**Not Small CCPC** If we assume that Madco Ltd. is not a small CCPC, the first two instalments would be due on the last day of January and February, 2019. They would be based on the second preceding year and would be $2,667 each ($32,000 ÷ 12). The remaining 10 instalments would be based on the preceding year, less the $5,334 paid in the first two instalments. The amount would be $5,367 [($59,000 - $5,334) ÷ 10] and the instalments would be due on the last day of each month for March to December, 2019.

**Small CCPC** If we assume that Madco Ltd. is a small CCPC, the first instalment would be due on March 31, 2019. The amount would be based on the second preceding year and would equal $8,000 ($32,000 ÷ 4). The remaining three instalments would be based on the preceding year, less the amount paid in the first instalment. These payments would be equal to $17,000 [($59,000 - $8,000) ÷ 3]. These payments would be due on the last days of June, September, and December, 2019.

Note that when the initial instalment(s) are based on the second preceding year, the total amount of instalments will be the same as when all of the instalments are based on the first preceding year. However, using the second preceding year is preferable in that it provides some deferral of taxes.

### *Exercise Two - 8 Solution*

**Not Small CCPC** If we assume that Fadco is not a small CCPC, the minimum instalments would be based on the estimated taxes payable for the taxation year ending November 30, 2019. The amount would be $1,417 ($17,000 ÷ 12) and the instalments would be due on the last day of each month beginning in December, 2018 and continuing to November, 2019. Note that, if the estimate of tax payable for 2019 is too low, interest may be assessed on the deficiency.

**Small CCPC** If we assume that Fadco is a small CCPC, the instalments would be based on the estimated taxes payable for the taxation year ending November 30, 2019. The amount would be $4,250 ($17,000 ÷ 4). These amounts would be due on the last days of February, May, August, and November, 2019.

### *Exercise Two - 9 Solution*

Radco Inc.'s tax return is due six months after the fiscal year end, on July 31, 2019. Unless Radco is able to claim the small business deduction, the final payment on their taxes is due two months after the year end, on March 31, 2019. If Radco is eligible for the small business deduction, the final payment can be deferred for an additional month, to April 30, 2019, provided the Taxable Income for the preceding taxation year did not exceed $500,000.

### *Exercise Two - 10 Solution*

The notice of objection must be filed by the later of:

- 90 days after the date on the Notice of Reassessment (August 13, 2021); or
- one year after the due date for filing the return that is being reassessed (April 30, 2021).

The later of these two dates is August 13, 2021.

## Self Study Solution Two - 1

#### *Need For Instalments*

Instalments are required when an individual's "net tax owing" exceeds $3,000 in the current year and in either of the two preceding years. In somewhat simplified terms, "net tax owing" is defined as the combined federal and provincial taxes payable, less amounts withheld under ITA 153. Mr. Grafton's net tax owing figures are as follows:

**2017** = $1,700 ($31,500 - $29,800)
**2018** = $8,400 ($14,600 - $6,200)
**2019** = $3,100 ($27,400 - $24,300) Estimated

As Mr. Grafton's net tax owing in 2019 (the current year) and his net tax owing in 2018 (one of the two preceding years) is greater than $3,000, he is required to make instalment payments.

#### *Amounts*

If Mr. Grafton bases the first two quarterly payments on the 2017 net tax owing, they would only be $425 each ($1,700 ÷ 4). However, the payments for the last two quarters would be $3,775 each {[$8,400 - (2)($425)] ÷ 2}, resulting in total instalment payments of $8,400.

A preferable alternative would be to base the payments on the net tax owing for 2019. These payments would be $775 each ($3,100 ÷ 4), for a total of $3,100.

#### *Payment Dates*

The quarterly payments would be due on March 15, June 15, September 15, and December 15.

## Self Study Solution Two - 2

#### *Case One*

1. As the corporation's tax payable for both the current and the preceding year exceeds $3,000, instalments are required. As the corporation is not a small CCPC, monthly instalments are required.

2. The three acceptable alternatives would be as follows:
   - Monthly instalments of $9,435 ($113,220 ÷ 12) based on the current year estimate.
   - Monthly instalments of $10,185 ($122,220 ÷ 12) based on the first preceding year.
   - Two monthly instalments of $8,640 ($103,680 ÷ 12) based on the second preceding year, followed by 10 monthly instalments of $10,494 {[($122,220 - (2)($8,640)] ÷ 10}, a total of $122,220.

3. The best alternative in terms of minimum instalments would be 12 instalments of $9,435, resulting in a total of $113,220 of instalment payments.

   The instalments would be due on the last day of each month, beginning in January, 2019.

### Case Two

1. As the corporation's tax payable for both the current and the preceding year exceeds $3,000, instalments are required. As the corporation is not a small CCPC, monthly instalments are required.

2. The three acceptable alternatives would be as follows:

   - Monthly instalments of $9,435 ($113,220 ÷ 12) based on the current year estimate.
   - Monthly instalments of $9,210 ($110,520 ÷ 12) based on the first preceding year.
   - Two monthly instalments of $8,640 ($103,680 ÷ 12) based on the second preceding year, followed by 10 monthly instalments of $9,324 {[($110,520 - (2)($8,640)] ÷ 10}, a total of $110,520.

3. The best alternative would be two payments of $8,640, followed by ten payments of $9,324. While the total instalments are the same $110,520 in both the second and third alternatives, the third alternative is preferable because the first two payments are lower. This provides a small amount of tax deferral.

   The instalments would be due on the last day of each month, beginning in January, 2019.

### Case Three

1. As the corporation's tax payable for both the current and the preceding year exceeds $3,000, instalments are required. As the corporation is a small CCPC, instalments will be quarterly.

2. The three acceptable alternatives would be as follows:

   - Quarterly instalments of $28,305 ($113,220 ÷ 4) based on the current year estimate.
   - Quarterly instalments of $30,555 ($122,220 ÷ 4) based on the first preceding year.
   - One instalment of $25,920 ($103,680 ÷ 4) based on the second preceding year, followed by three instalments of $32,100 [($122,220 - $25,920) ÷ 3], a total of $122,220.

3. The best alternative in terms of minimum instalments would be four instalments of $28,305, for total payments of $113,220. The instalments are due on March 31, June 30, September 30, and December 31, 2019.

### Case Four

1. As the corporation's tax payable for both the current and the preceding year exceeds $3,000, instalments are required. As the corporation is a small CCPC, instalments will be quarterly.

2. The three acceptable alternatives would be as follows:

   - Quarterly instalments of $28,305 ($113,220 ÷ 4) based on the current year estimate.
   - Quarterly instalments of $27,630 ($110,520 ÷ 4) based on the first preceding year.
   - One instalment of $25,920 ($103,680 ÷ 4) based on the second preceding year, followed by three instalments of $28,200 [($110,520 - $25,920) ÷ 3], a total of $110,520.

3. The best alternative would be one payment of $25,920, followed by three payments of $28,200. While the total instalments are the same $110,520 in both the second and third alternatives, the third alternative is preferable because the first payment is lower. This provides a small amount of tax deferral.

   The instalments are due on March 31, June 30, September 30, and December 31, 2019.

## Self Study Solution Two - 3

### *Case One*

1. The individual's net tax owing in each of the three years is as follows:

   **2017** = Nil ($72,300 - $73,700)
   **2018** = $6,200 ($89,400 - $83,200)
   **2019** = $3,300 ($78,300 - $75,000)

   As the net tax owing exceeds $3,000 in the current year and one of the two preceding years, instalments are required.

2. The three alternatives would be:

   - Quarterly instalments of $825 ($3,300 ÷ 4) based on the current year estimate.
   - Quarterly instalments of $1,550 ($6,200 ÷ 4) based on the first preceding year.
   - Based on the second preceding year, the first two instalments would be nil. The remaining two instalments would be $3,100 each [($6,200 -
   - Nil) ÷ 2] for a total of $6,200.

3. The best alternative to minimize instalments would be four quarterly instalments of $825, for a total of $3,300.

   The instalments are due on March 15, June, 15, September 15, and December 15.

### *Case Two*

1. The individual's net tax owing in each of the three years is as follows:

   **2017** = $7,200 ($72,300 - $65,100)
   **2018** = Nil ($89,400 - $90,100)
   **2019** = $6,400 ($78,300 - $71,900)

   As the net tax owing exceeds $3,000 in the current year and one of the two preceding years, instalments are required.

2. The three alternatives would be:

   - Quarterly instalments of $1,600 ($6,400 ÷ 4) based on the current year estimate.
   - Quarterly instalments of nil based on the first preceding year.
   - Two quarterly instalments of $1,800 ($7,200 ÷ 4) based on the second preceding year. No further instalments would be required.

3. The best alternative would be quarterly instalments of nil based on the first preceding year.

### *Case Three*

1. As the corporation's tax payable for both the current and the preceding year exceeds $3,000, instalments are required. As the corporation is a small CCPC, instalments will be quarterly.

2. The three acceptable alternatives would be as follows:

   - Quarterly instalments of $19,575 ($78,300 ÷ 4) based on the current year estimate.
   - Quarterly instalments of $22,350 ($89,400 ÷ 4) based on the first preceding year.
   - One instalment of $18,075 ($72,300 ÷ 4) based on the second preceding year, followed by three instalments of $23,775 [($89,400 - $18,075) ÷ 3], a total of $89,400.

3. The best alternative would be four instalments of $19,575, for total payments of $78,300.

   The instalments are due on March 31, June 30, September 30, and December 31.

***Case Four***

1. As the corporation's tax payable for both the current and the preceding year exceeds $3,000, instalments are required. As the corporation is not a CCPC so cannot be eligible for the small business deduction, monthly instalments are required.

2. The three acceptable alternatives would be as follows:

   - Monthly instalments of $6,525 ($78,300 ÷ 12) based on the current year estimate.
   - Monthly instalments of $6,208.33 ($74,500 ÷ 12) based on the first preceding year.
   - Two monthly instalments of $6,025 ($72,300 ÷ 12) based on the second preceding year, followed by 10 monthly instalments of $6,245 {[($74,500 - (2)($6,025)] ÷ 10}, a total of $74,500.

3. In terms of minimizing instalment payments, both the second and third alternatives involve paying $74,500, which is less than the payment of $78,300 under the first alternative. While the problem does not ask you to take into consideration deferral, the third alternative would be the best in that the first two payments are lower.

   The instalments would be due on the last day of each month, beginning in January.

## Self Study Solution Two - 4

***Case A***

The individual's actual and estimated net tax owing is equal to the Tax Payable in each of the three years as follows:

**2017** = $18,000
**2018** = $14,400
**2019** = $13,500 (Estimated)

As the estimated tax payable for the current year and the actual tax payable for the preceding year exceeds $3,000, instalments are required.

Using the estimated Tax Payable for the current year would result in the minimum instalment payments. Based on this year, the required quarterly instalments would be $3,375 ($13,500 ÷ 4).

They would be due on March 15, June 15, September 15, and December 15 and would total $13,500.

Since the actual federal and provincial taxes payable for 2019 of $16,000 is higher than the tax payable of $14,400 of the preceding year, the instalments should have been based on $14,400. The instalments should have been $3,600 ($14,400 ÷ 4) for each quarter.

Interest at the prescribed base rate plus 4 percent is charged on any portion of a required instalment payment that is not remitted on the required instalment due date. The interest is charged from the date the instalment is due until an offset occurs, or until the due date for the balance owing.

***Case B***

The individual's net tax owing in each of the three years is as follows:

**2017** = $11,000 ($18,000 - $7,000)
**2018** = Nil (Withholdings exceed tax payable. Note this is nil, not a negative amount.)
**2019** = $4,500 ($13,500 - $9,000) (Estimated)

As the individual's net tax owing is expected to exceed $3,000 in 2019 and was more than $3,000 in 2017, the payment of instalments is required.

Using the 2018 net tax owing would result in minimum instalment payments. Based on this year, the required quarterly instalments would be nil.

The fact that the actual federal and provincial taxes payable for 2019 are higher than were estimated is not relevant in this Case.

***Case C***

The corporation's Tax Payable for the three years is as follows:

**2017** = $18,000
**2018** = $14,400
**2019** = $13,500 (Estimated)

As the corporation's tax payable for both the current and the preceding year exceeds $3,000, instalments are required.

Using the estimated Tax Payable for the current year would result in the minimum instalment payments. As the corporation is a small CCPC, the required instalments would be quarterly. The amount would be $3,375 ($13,500 ÷ 4).

They would be due on the last days of March, June, September, and December, 2019.

Like Case A, since the actual federal and provincial taxes payable for 2019 of $16,000 is higher than the tax payable of $14,400 of the preceding year, the instalments should have been based on $14,400. The instalments should have been $3,600 ($14,400 ÷ 4) for each quarter.

Interest at the prescribed base rate plus 4 percent is charged on any portion of a required instalment payment that is not remitted on the required instalment due date. The interest is charged from the date the instalment is due until an offset occurs, or until the due date for the balance owing.

***Case D***

The corporation's Tax Payable for the three years is as follows:

**2017** = $18,000
**2018** = $14,400
**2019** = $16,000 (Estimated and actual)

As the corporation's tax payable for both the current and the preceding year exceeds $3,000, instalments are required.

Using the estimated Tax Payable for 2018 would result in minimum instalment payments. As the corporation is not a CCPC so cannot be eligible for the small business deduction, the required instalments would be monthly. The amount would be $1,200 ($14,400 ÷ 12). They would be due on the last day of each month, beginning in January, 2019.

## Self Study Solution Two - 5

The three taxable entities are individuals, corporations, and trusts. The required information for each is as follows:

**Individuals** For individuals, the taxation year is the calendar year. For individuals without business income, the filing deadline is April 30 of the following year. Individuals with business income, and their spouse or common-law partner, have an extended filing deadline of June 15.

If an individual dies after October, the due date of the return for the year of death is extended to 6 months after the date of death. Instalment payments for all individuals, if required, are to be made quarterly on March 15, June 15, September 15, and December 15.

**Corporations** Corporations can choose any fiscal year that does not exceed 53 weeks. The filing deadline is six months after the fiscal year end. In general, corporations must make instalments on the last day of each month. However, if the corporation qualifies as a small CCPC, quarterly instalments are required on the last day of the last month of each 3 month period in the corporation's taxation year.

**Trusts - Inter Vivos** Inter vivos trusts must use the calendar year as their taxation year. As the required tax return must be filed within 90 days of the taxation year end, returns for inter vivos trusts will be due March 31 (March 30 in leap years). Legislation requires that quarterly instalments be made on March 15, June 15, September 15, and December 15. Note, however, the CRA has generally not enforced this requirement.

**Trusts - Testamentary** The rules are the same for most testamentary trusts. However, the exception to this is a testamentary trust that has been designated a graduated rate estate (GRE). Such GREs can use a non-calendar fiscal year for up to three years subsequent to the death of the settlor. GRE returns are due 90 days after the date that has been selected as the taxation year end. Quarterly instalments are required, with the specific dates determined by the choice of taxation year end. It is likely that the CRA will not enforce the instalment requirement.

## Self Study Solution Two - 6

Since Mr. Coffee has been your client for many years, there should be a signed Consent Form, T1013, filed with the CRA which authorizes you to represent him in his affairs. If you have not already been authorized to represent him online, it would be advantageous for you to request that Mr. Coffee take the steps needed to authorize you to access his file through the

online Represent a Client service. This will enable you to deal with this dispute and any future disputes more quickly.

With respect to resolving this dispute, the first step would be a call to the CRA to discuss the matter. If there has been a misunderstanding of the facts, an error on your or the CRA's part, or missing information, this may be the only step required and the matter can be resolved.

However, if more formal steps are necessary they can be outlined as follows:

**Notice of Objection** As the reassessment relates to the previous year's tax return, it is within the normal three year time limit for reassessment. This means that notice of objection can be filed within 90 days of the date on the Notice of Reassessment or (as Mr. Coffee is an individual) one year from the due date for the return under reassessment. This can be done through the mail by letter or using Form T400A, or online through the Represent A Client service. It should explain the facts and reasons why the reassessment is not justified.

**Tax Court of Canada** If there is an adverse decision on the notice of objection, Mr. Coffee has up to 90 days after the mailing date of the response to the notice of objection to appeal to the Tax Court of Canada. Alternatively, if he does not receive a response to his notice of objection within 90 days, he will then be able to appeal to the Tax Court of Canada. As the amount involved is only $5,000, it would probably be advisable for Mr. Coffee to choose the informal procedures.

**Federal Courts** If Mr. Coffee has elected the informal Tax Court of Canada procedures, no appeal of an adverse decision is possible. An appeal to the Federal Court - Appeals Division would, however, be possible if an adverse decision was rendered under the general procedures. In theory, an adverse decision by the Federal Court could be appealed to the Supreme Court of Canada. However, this can only happen if the Federal Court recommends it or the Supreme Court authorizes such action. This would be extremely unlikely given the amount involved.

## Self Study Solution Two - 7

***Part A***

Based on these facts, Joan Bridge would be liable for a third party penalty. However, if she was able to determine that there was a reasonable basis upon which the Tax Court decision could be overturned by a higher court, the penalty would not apply.

***Part B***

Based on these facts, if Jack Hodge were to prepare and EFILE Barbra's return without obtaining the charitable donation receipt, Jack would be liable for a third party penalty. Given that the size of the donation is so disproportionate to Barbra's apparent income as to defy credibility, to EFILE the return without verifying the amount of the receipt would show an indifference as to whether the *Act* is complied with or would show a wilful, reckless, or wanton disregard of the law.

***Part C***

Marion Flexor is not liable for participating in an understatement of Jason March's taxes payable because she did not know that some of the expense receipts were personal in nature, and would not be reasonably expected to know that this was the case. This is because Marion relied in good faith on the information provided by Jason. Unlike the situation in Part B of this problem, since Jason's business had a significant profit, it would be reasonable to assume he had high travel costs.

## Chapter 2 Learning Objectives

After completing Chapter 2, you should be able to:

1. Explain when an individual is required to file an income tax return (paragraph [P hereafter] P 2-8 to 2-14).
2. List the dates on which income tax returns must be filed by living and deceased individuals (P 2-15 to 2-20).
3. Explain the nature of, and need for, withholding for income tax (P 2-21 to 2-27).
4. Explain the circumstances which result in an individual having to make income tax instalment payments (P 2-28 to 2-32).
5. Calculate the amount of any income tax instalment payments required for individual taxpayers and determine their due date (P 2-33 to 2-43).

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6. Explain how the prescribed interest rates are used to calculate interest on amounts owing to and from the CRA (P 2-44 to 2-50).
7. Calculate the penalties that will be assessed for the late filing of income tax returns and large late and deficient instalments (P 2-51 to 2-55).
8. Identify the dates on which balances owing by living and deceased individuals are due (P 2-56 and 2-60).
9. Identify the dates on which income tax returns must be filed by corporations and the filing alternatives that are available (P 2-61 to 2-67).
10. Calculate the amount of income tax instalment payments required for corporations, including small CCPCs (P 2-68 to 2-73).

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11. Identify the dates on which balances owing by corporations are due (P 2-74 and 2-75).
12. Calculate the interest and penalties that will be assessed on late tax payments and for the late filing of corporate income tax returns (P 2-76 to 2-79).
13. Explain the general filing and payment requirements for testamentary and inter vivos trusts (P 2-80 to 2-87).
14. Explain the circumstances in which a taxpayer is required to file an information return (P 2-88).
15. Describe the record keeping requirements of the CRA (P 2-89 and 2-90).

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16. Briefly describe the My Account and My Business Account services available on the CRA website (P 2-91).
17. Describe the Notice of Assessment, Notice of Reassessment and explain the reassessment period (P 2-92 to 2-94).
18. Explain when interest is paid on refunds and how it is calculated (P 2-95 to 2-100).
19. Explain how to make adjustments to previously filed tax returns (P 2-101 to 2-104).
20. Explain the initial procedures for disputing an assessment and the procedures for filing a notice of objection (P 2-105 to 2-120).

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21. Describe further appeals procedures, including those made to the Tax Court of Canada, the Federal Court of Appeals, and the Supreme Court of Canada (P 2-121 to 2-130).
22. Explain the difference between tax evasion, avoidance and planning, including the concepts involved in the General Anti-Avoidance Rule (P 2-131 to 2-140).
23. Describe the collection and enforcement procedures available to the CRA (P 2-141 to 2-146).
24. Describe some of the penalties that can be assessed including those applicable to tax advisors and tax return preparers (P 2-147 to 2-152).
25. Briefly describe the taxpayer relief provisions (P 2-153 to 2-156).

# CHAPTER 3

## How To Work Through Chapter 3

We recommend the following approach in dealing with the material in this chapter:

**Employment Income Defined**

- Read paragraph 3-1 to 3-11 (in the textbook).
- Do Exercise Three-1 (in the textbook) and check the solution in this Study Guide.
- Do Self Study Problem Three-1 which is available on MyLab and check the solution in this Study Guide.
- Read paragraph 3-12 to 3-13.

**Employee Versus Self-Employed**

- Read paragraph 3-14 to 3-44.
- Do Self Study Problem Three-2 and check the solution in this Study Guide.

**Salaries And Fringe Benefits**

- Read paragraph 3-45 to 3-63.
- Do Exercises Three-2 and Three-3 and check the solutions in this Study Guide.
- Read paragraph 3-64 to 3-76.
- Do Exercise Three-4 and check the solution in this Study Guide.

**GST/HST/PST On Taxable Benefits**

- Read paragraph 3-77 to 3-78.
- Do Exercise Three-5 and check the solution in this Study Guide.

**Automobile Benefits (Standby Charge And Operating Cost Benefit)**

- Read paragraph 3-79 to 3-116.
- Do Exercise Three-6 and check the solution in this Study Guide.
- Read paragraph 3-117 to 3-122.
- Do Exercise Three-7 and check the solution in this Study Guide.
- Read paragraph 3-123 and 3-124.
- Do Self Study Problems Three-3 to Three-5 and check the solutions in this Study Guide.

**Allowances**

- Read paragraph 3-125 to 3-137.
- Do Exercises Three-8 and Three-9 and check the solutions in this Study Guide.
- Read paragraph 3-138 to 3-142.
- Do Exercise Three-10 and check the solution in this Study Guide.

**Employee Insurance Benefits**

- Read paragraph 3-143 to 3-148.
- Do Exercise Three-11 and check the solution in this Study Guide.

### Loans To Employees

- Read paragraph 3-149 to 3-151.
- Do Exercise Three-12 and check the solution in this Study Guide.
- Read paragraph 3-152 to 3-156.
- Do Exercise Three-13 and check the solution in this Study Guide.
- Do Self Study Problem Three-6 and check the solution in this Study Guide.

### Stock Option Benefits

- Read paragraph 3-157 to 3-171.
- Do Exercise Three-14 and check the solution in this Study Guide.
- Read paragraph 3-172 to 3-176.
- Do Exercise Three-15 and check the solution in this Study Guide.
- Do Self Study Problems Three-7 to Three-9 and check the solutions in this Study Guide.

### Other Inclusions

- Read paragraph 3-177 to 3-185.

### Specific Deductions Including Salesperson's Expenses And Work Space In The Home Costs

- Read paragraph 3-186 to 3-202.
- Do Exercise Three-16 and check the solution in this Study Guide.
- Read paragraph 3-203 to 3-212.
- Do Self Study Problems Three-10 to Three-14 and check the solutions in this Study Guide.

### To Complete This Chapter

- If you would like more practice in problem solving, do the Supplementary Self Study Problems for the chapter. These problems and solutions are available on MyLab.
- Review the Key Terms Used In This Chapter in the textbook at the end of Chapter 3. Consult the Glossary for the meaning of any key terms you do not know.
- Test yourself with the Chapter 3 Glossary Flashcards available on MyLab.
- Ensure you have achieved the Chapter 3 Learning Objectives listed in this Study Guide.
- As a review, we recommend you view the PowerPoint presentation for Chapter 3 that is on MyLab.

### Practice Examination

- Write the Practice Examination for Chapter 3 that is on MyLab. Mark your examination using the Practice Examination Solution that is also on MyLab.

## Solutions to Chapter Three Exercises

### *Exercise Three - 1 Solution*

The bonus will be taxed in Mr. Neelson's hands in the year of receipt. This means that it will be included in his 2020 tax return. With respect to Neelson Inc., the bonus is not payable until more than 180 days after the September 30 fiscal year end. Note that the limit is 180 days from the fiscal year end, not the date on which the bonus was declared.

As a consequence, the Company will not be able to deduct the bonus in the year ending September 30, 2019, the year of declaration. It will be deducted in the year ending September 30, 2020, the year of payment.

### *Exercise Three - 2 Solution*

The tax consequences associated with each of the listed items are as follows:

| Gift | Tax Consequence |
|---|---|
| $15 T-Shirt | No consequences as value is immaterial |
| $75 Birthday Gift | Taxable as it is a near cash gift |
| $400 Performance Reward | Taxable as it is performance related |
| $275 10-Year Award | Non-taxable as it is under $500 |
| $300 Wedding Gift | These remaining three gifts qualify as non-taxable. However, their total value is $700 ($300 + $250 + $150). The $200 excess over $500 will be taxable. |
| $250 Weight Loss Award | |
| $150 Holiday Season Gift | |

### *Exercise Three - 3 Solution*

The tax consequences of the various items would be as follows:

- Discounts on merchandise do not create a taxable benefit provided they are available to all employees and do not reduce the price below the employer's cost.
- It could be argued that these tuition fees are related to business activity. If the argument is successful, the payment would not be taxable to John. If unsuccessful, the $2,000 would be a taxable benefit.
- Special clothing is not a taxable benefit if it is distinctive and the employee is required to wear it at work, or if it is required to protect the employee from some type of employment related hazard. It is unlikely that business clothing would fall into this category as it could be used for personal purposes. The $8,500 should be included in John's income as a taxable benefit.
- The $450 gift would not be taxable to John.
- Employer paid premiums for private health care plans are not a taxable benefit.

### *Exercise Three - 4 Solution*

From Jill's point of view, the best alternative is probably the dental plan. Its value is significantly enhanced by the fact that it can be received without tax consequences. The annual vacation trip is clearly a taxable benefit. With respect to the $4,000 birthday gift, the $3,500 excess over the limit of $500 will be taxable. Note that the desirability of the dental plan would be affected by whether her spouse has a dental plan.

### Exercise Three - 5 Solution

Ms. Correli's taxable benefit would be $4,725, the $4,500 cost of the trip, plus the additional $225 in GST.

### Exercise Three - 6 Solution

As Mrs. Lee's employment related use is more than 50 percent of the total (16,000 out of 28,000), she is eligible for a reduction in the full standby charge. She is also eligible for the alternative one-half of the standby charge calculation of the operating cost benefit. Given these factors, the taxable benefit would be calculated as follows:

| | |
|---|---|
| Standby Charge | |
| [(2%)(12)($25,000 + $1,250 + $2,000)(12,000 ÷ 20,004*)] | $4,067 |
| Operating Cost Benefit - Lesser Of: | |
| • [($0.28)(12,000)] = $3,360 | |
| • [(1/2)($4,067)] = $2,034 | 2,034 |
| Total Benefit | $6,101 |

*[(12 Months)(1,667)]

### Exercise Three - 7 Solution

The actual operating costs paid by the employer do not affect these calculations. Rounded to the nearest whole number, 325 days results in 11 months of availability. As Mr. Forthwith's employment related use is more than 50 percent, he is eligible for a reduction in the full standby charge. He is also eligible for the alternative one-half of the standby charge calculation of the operating cost benefit. Given these factors, the taxable benefit would be calculated as follows:

| | |
|---|---|
| Standby Charge [(2/3)($525 + $68)(11)(3,000 ÷ 18,337*)] | $ 711 |
| Operating Cost Benefit - Lesser Of: | |
| • [($0.28)(3,000)] = $840 | |
| • [(1/2)($711)] = $356 | 356 |
| Total Benefit | $1,067 |

*[(11)(1,667)]

### Exercise Three - 8 Solution

Because the allowance is not based on kilometers driven, she will have to include the $3,600 allowance in her income. Because the allowance has been included in income, she can deduct the employment related portion of her actual automobile costs against this amount. This would be $1,936 [($7,150)(6,500 ÷ 24,000)]. The net inclusion would be $1,664 ($3,600 - $1,936).

### Exercise Three - 9 Solution

As the milage allowance paid by the employer was based on the number of employment related kilometers driven, the $3,500 [(35,000 Km.)($0.10)] will not be included on his T4 Information Return and, as a consequence, it does not have to be included in his employment income. However, he will not be able to deduct his actual costs of owning and operating the automobile.

Mr. Lorenz's actual deductible costs total $11,900 [($5,400 + $15,000)(35,000/60,000)], well in excess of the allowance of $3,500. While Mr. Lorenz could attempt to include the allowance in income and deduct the actual costs, this approach could be disallowed by the CRA.

### *Exercise Three - 10 Solution*

The hotel allowance would appear to be reasonable and would not be included in Ms. Ohm's T4. Given this, it will not be included in her net employment income. Even though her actual costs of $18,300 are in excess of the $16,400 allowance, it would be difficult for Ms. Ohm to argue that the $200 figure is not reasonable. Given this, she does not have the choice of including the $16,400 in income and deducting the actual amount of $18,300.

As the milage charge is based on kilometers, it will not be included in her T4. In addition, since the amount appears to be reasonable in terms of actual costs, she does not have the choice of including it in income and deducting the actual costs. In fact, it would not be to Ms. Ohm's advantage to do so as her actual costs would be $2,880 [($7,200)(9,400/23,500)], which is less than the $3,854 payment she received.

No amounts would be included in Ms. Ohm's net employment income and no amounts would be deductible.

### *Exercise Three - 11 Solution*

As his employer contributes to the plan and the contributions do not create a taxable benefit, the $5,250 in benefits received during the year will be included in his employment income. This will be reduced by the $525 ($300 + $225) in non-deductible contributions that he made during 2018 and 2019, leaving a net inclusion of $4,725 ($5,250 - $525).

### *Exercise Three - 12 Solution*

The ITA 80.4(1) benefit is calculated as follows:

| | |
|---|---|
| The Lesser Of: | |
| • [($100,000)(2%)(1/4) + ($100,000)(3%)(1/4) + ($100,000)(1%)(2/4)] = $1,750 | |
| • [($100,000)(2%)] = $2,000 | $1,750 |
| Less Interest Payment [($100,000)(1%)] | ( 1,000) |
| Net Benefit | $ 750 |

As this is a home purchase loan, the annual benefit cannot exceed the benefit that would result from applying the 2 percent rate that was in effect when the loan was made. Note that the 2 percent rate is not compared to the prescribed rate on a quarter-by-quarter basis, but on an annual basis. The lower figure of $1,750 would then be reduced by the $1,000 in interest paid.

### *Exercise Three - 13 Solution*

In the absence of the interest free loan, the employee would borrow $125,000 at 5 percent, requiring an annual interest payment of $6,250. The after tax cash outflow associated with the employer providing sufficient additional salary to carry this loan would be calculated as follows:

| | |
|---|---|
| Required Salary [$6,250 ÷ (1 - 0.42)] | $10,776 |
| Corporate Tax Savings From Deducting Salary [($10,776)(26%)] | ( 2,802) |
| Employer's After Tax Cash Flow - Additional Salary | $ 7,974 |

Alternatively, if the loan is provided, the employee will have a taxable benefit of $2,500 [(2%)($125,000)], resulting in taxes payable of $1,050 [(42%)($2,500)]. To make this situation comparable to the straight salary alternative, the employer will have to provide the employee with both the loan amount and sufficient additional salary to pay the taxes on the imputed interest benefit. The amount of this additional salary would be $1,810 [$1,050 ÷ (1 - 0.42)]. The employer's after tax cash flow associated with providing the additional salary and the loan amount would be calculated as follows:

| | |
|---|---|
| Required Salary [$1,050 ÷ (1 - 0.42)] | $1,810 |
| Corporate Tax Savings From Deducting Salary [($1,810)(26%)] | ( 471) |
| After Tax Cost Of Salary To Cover Taxes On Benefit | $1,339 |
| Employer's Lost Earnings [(7%)(1 - 0.26)($125,000)] | 6,475 |
| Employer's After Tax Cash Flow - Loan | $7,814 |

Given these results, providing the loan appears to be the better alternative.

### *Exercise Three - 14 Solution*

At time of exercise, Mr. Guise will have an employment income benefit of $21,250 [($31.50 - $23.00)(2,500 Shares)]. As the option price at issue exceeded the fair market value at issue, Mr. Guise will be able to deduct $10,625 [(1/2)($21,250)] in the determination of Taxable Income. These results are summarized in the following table:

| | |
|---|---|
| Fair Market Value Of Shares Acquired [(2,500)($31.50)] | $78,750 |
| Cost Of Shares [(2,500)($23)] | ( 57,500) |
| ITA 7(1)(a) Employment Income Inclusion = **Increase In Net Income For Tax Purposes** | **$21,250** |
| ITA 110(1)(d) Deduction [(1/2)($21,250)] | ( 10,625) |
| **Increase In Taxable Income** | **$10,625** |

When the shares are sold, there will be an allowable capital loss, calculated as follows:

| | |
|---|---|
| Proceeds Of Disposition [($28.00)(2,500)] | $70,000 |
| Adjusted Cost Base [($31.50)(2,500)] | ( 78,750) |
| Capital Loss | ($ 8,750) |
| Inclusion Rate | 1/2 |
| Allowable Capital Loss | ($ 4,375) |

Mr. Guise will only be able to deduct this loss in 2019 to the extent that he has taxable capital gains on other dispositions. It cannot be deducted against the employment income inclusion.

### *Exercise Three - 15 Solution*

There will be no tax consequences in either 2017 when the options are received, or in 2018, when the options are exercised. This latter result reflects the fact that the acquired shares are those of a Canadian controlled private corporation.

At the time the shares are sold in 2019, there will be an employment income benefit of $58,500 [($75.00 - $42.50)(1,800 Shares)]. As the option price of $42.50 was below the fair market value of $45 at the time the options were issued, there is no deduction under ITA 110(1)(d). Although she could have been eligible for the deduction under ITA 110(1)(d.1), she did not hold the shares for the required two years. These results are summarized in the following table:

| | |
|---|---|
| Deferred Employment Income: | |
| Fair Market Value Of Shares Acquired [(1,800)($75)] | $135,000 |
| Cost Of Shares [(1,800)($42.50)] | ( 76,500) |
| ITA 7(1)(a) Employment Income Inclusion = Increase In **Net Income For Tax Purposes** | **$ 58,500** |
| ITA 110(1)(d) Deduction (Option Price < FMV) | N/A |
| ITA 110(1)(d.1) Deduction (Held Less Than 2 Years) | N/A |
| Increase In **Taxable Income** | **$ 58,500** |

When she sells the shares in 2019, Ms. Van will have an allowable capital loss calculated as follows:

| | |
|---|---|
| Proceeds Of Disposition [($49)(1,800)] | $ 88,200 |
| Adjusted Cost Base [($75)(1,800)] | ( 135,000) |
| Capital Loss | ($ 46,800) |
| Inclusion Rate | 1/2 |
| Allowable Capital Loss | ($ 23,400) |

Ms. Van will only be able to deduct this loss in 2019 to the extent that she has taxable capital gains on other dispositions. It cannot be deducted against the employment income inclusion.

***Exercise Three - 16 Solution***

The potential deduction is $27,100 [$8,000 + (1/2)($12,000) + $13,100]. However, this total exceeds his commissions and, if these amounts are deducted under ITA 8(1)(f), his deduction will be limited to the commissions of $12,200.

Alternatively, if he uses ITA 8(1)(h), he cannot deduct the advertising or the entertainment, limiting the amount of this deduction to $13,100.

As the two provisions cannot be used simultaneously, Morton would use the larger figure of $13,100 that is available under ITA 8(1)(h).

## Self Study Solution Three - 1

The required information for the four Cases included in this problem is as shown in the following table:

| | Deduction - Empire Inc. Year Ending October 31 | Inclusion-Ms. Betz Calendar Year |
|---|---|---|
| Case A | 2019 | 2019 |
| Case B | 2019 | 2020 |
| Case C | 2020 | 2020 |
| Case D | 2019 | 2019 |

In Case A, the bonus is deducted when accrued because it is paid within 180 days of Empire's 2019 year end. It is taxed when received.

In Case B, the bonus is deducted when accrued because it is paid within 180 days of Empire's 2019 year end. It is taxed when received.

In Case C, the bonus is not paid within 180 days of Empire's year end. As a consequence, it cannot be deducted until the year ending October 31, 2020. However, as it is paid within 3 years of Empire's 2019 year end it is not a salary deferral arrangement. This means it does not have to be included in Ms. Betz's Taxable Income until 2020.

In Case D, the bonus is not paid until more than 3 years after the end of the calendar year in which Ms. Betz rendered the services. This makes it a salary deferral arrangement, resulting in Ms. Betz having to include it in her 2019 Taxable Income. Empire will deduct the bonus in the fiscal year ending October 31, 2019.

## Self Study Solution Three - 2

### *Quantitative Considerations*

If the individual's services are acquired as an employee, the 2019 costs would be as follows:

| | |
|---|---|
| Basic Salary | $250,000 |
| Company Benefits [($250,000)(8%)] | 20,000 |
| CPP (Maximum) | 2,749 |
| Employer's Share Of EI [(1.4)(1.62%)($53,100)] | 1,204 |
| Payroll Tax [(2%)($250,000)] | 5,000 |
| Total Cost | $278,953 |

This is very close to the $280,000 that would have to be paid to the individual if he is classified as an independent contractor.

### *Other Considerations*

While the quantitative factors slightly favour employee classification, this is probably not the best choice. Other factors that should be considered:

- self-employed status relieves the company from any ongoing commitment beyond the period specified in the contract,
- Farnham Ltd. would not be legally responsible for any errors in the work of the engineer if he is self-employed,
- the fact that employment contracts usually require that salary and related benefits grow over time, and
- the added administrative costs of withholding amounts from his salary if he is an employee.

It would appear to be more advantageous to structure the arrangement so that this individual qualifies as an independent contractor.

## Self Study Solution Three - 3

### *Acura TLX*

With employment related usage at more than 50 percent of the total, Ms. Vines can reduce the standby charge on the basis of actual personal usage and Ms. Vines can calculate the operating cost benefit as one-half of the standby charge which results in a lower benefit. The taxable benefit on this vehicle would be calculated as follows:

| | |
|---|---|
| Standby Charge [(2%)($39,000 + $2,340 + $1,950)(5)(3,400 ÷ 8,335*)] | $1,766 |
| Operating Cost Benefit - Lesser Of: | |
| • [(3,400)($0.28)] = $952 | |
| • [(1/2)($1,766)] = $883 | 883 |
| Total Benefit On Acura TLX | $2,649 |

*[(5)(1,667)]

### *Buick Lacrosse*

The $100 insurance included in the monthly lease payment is removed from the standby charge calculation as it is an operating cost.

As the car was driven more than 50 percent for employment related purposes, a reduction in the standby charge is available (but is nil in this case) and Ms. Vines can calculate the operating cost benefit as one-half of the standby charge which results in a lower benefit. The taxable benefit on this vehicle is calculated as follows:

| | |
|---|---|
| Standby Charge [(2/3)(6)($699 - $100)(10,002* ÷ 10,002*)] | $2,396 |
| Operating Cost Benefit - Lesser Of: | |
| • [(14,600)($0.28)] = $4,088 | |
| • [(1/2)($2,396)] = $1,198 | 1,198 |
| Total Benefit On Buick Lacrosse | $3,594 |

*[(6)(1,667)] - since the numerator (personal kilometers of 14,600) cannot exceed the denominator, the effect of applying the reduction fraction is nil (10,002 ÷ 10,002).

***Total Benefit***

The total taxable benefit would be calculated as follows:

| | |
|---|---|
| Total Benefit - Acura | $2,649 |
| Total Benefit - Buick | 3,594 |
| Reimbursement To Company [($0.10)(3,400 Km + 14,600 Km)] | ( 1,800) |
| Total Taxable Benefit | $4,443 |

**Notes:**

- The taxable benefit calculation is not influenced by restrictions on the amount that the Company can deduct with respect to the Acura.
- Calculation of the operating cost benefits is not influenced by the employer's actual operating costs.

## Self Study Solution Three - 4

***Mr. Sam Stern***

The taxable benefit for the president of the Company would be calculated as follows:

| | |
|---|---|
| Standby Charge [(2%)($78,000)(8)] | $12,480 |
| Operating Cost Benefit [(32,000)($0.28)] | 8,960 |
| Taxable Benefit | $21,440 |

As Mr. Stern did not drive the car more than 50 percent for employment related purposes, no reduction in the standby charge is available. Since his employment related use was not more than 50 percent, he cannot use the alternative calculation of the operating cost benefit.

***Ms. Sarah Blue***

The taxable benefit for the marketing vice president would be calculated as follows:

| | |
|---|---|
| Standby Charge [(2/3)(12)($900)(5,000/20,004)] | $1,800 |
| Operating Cost Benefit - Lesser Of: | |
| • [(5,000)($0.28)] = $1,400 | |
| • [(1/2)($1,800)] = $900 | 900 |
| Taxable Benefit | $2,700 |

As employment related driving was more than 50 percent of the total, Ms. Blue can reduce the standby charge on the basis of actual personal usage. As the car was driven more than 50 percent for employment related purposes, Ms. Blue can calculate the operating cost benefit as one-half of the standby charge which results in a lower benefit.

### *Mr. John Stack*

The taxable benefit for the finance vice president would be calculated as follows:

| | |
|---|---|
| Standby Charge [(2%)($48,000)(12)(10,000/20,004] | $5,759 |
| Operating Cost Benefit - Lesser Of: | |
| • [(10,000)($0.28)] = $2,800 | |
| • ](1/2)($5,759)] = $2,880 | 2,800 |
| Payment For Use Of Company Car | ( 7,000) |
| Taxable Benefit | $1,559 |

Mr. Stack's employment related driving was more than 50 percent of the total and, as a consequence, he can reduce his standby charge on the basis of actual personal milage. Mr. Stack could have calculated the operating cost benefit as one-half of the standby charge, but this would have resulted in a higher benefit.

### *Mr. Alex Decker*

The taxable benefit for the industrial relations vice president would be calculated as follows:

| | |
|---|---|
| Standby Charge [(2/3)(10)($500)(8,500/16,670)] | $1,700 |
| Operating Cost Benefit - Lesser Of: | |
| • [(8,500)($0.28)] = $2,380 | |
| • [(1/2)($1,700)] = $850 | 850 |
| Taxable Benefit | $2,550 |

As Mr. Decker's employment related driving is more than 50 percent of the total, he can reduce his standby charge on the basis of actual personal milage. While the $10,000 deposit will affect the deductibility of the lease payments by the employer, it does not influence the calculation of the taxable benefit to Mr. Decker. As the car was driven more than 50 percent for employment related purposes, Mr. Decker can calculate the operating cost benefit as one-half of the standby charge which results in a lower benefit.

### *Tax Planning*

With respect to the tax planning of management compensation, two points can be made. First, the question of providing company cars as a method of compensation should be examined on a case-by-case basis.

In situations where a car is owned by the Company and provided to an executive for a fairly long period of time, the taxable benefit assessed may exceed the value of the benefit. For example, over five years, the taxable benefit without regard for operating costs on Mr. Stern's Mercedes could total $93,600 [(2%)(60)($78,000)]. This is more than $15,000 in excess of the cost of the car.

With the limitations on the deductibility of CCA and leasing costs on cars, the after tax cost to the Company of owning and leasing luxury cars can be very high. While a complete analysis of this issue will depend on a number of variables, it is possible that some of these executives would be better off receiving additional amounts of salary and billing the Company for employment related mileage driven in their own cars.

The second point to be made here is that, except in situations where the car is kept for very short periods of time, the employee will be allocated a smaller taxable benefit if the Company were to lease the car rather than buy it. In general, monthly lease payments on a three year lease will tend to be between 2 percent and 2.5 percent of the capital cost of the cars.

As the leasing standby charge is based on two-thirds of the monthly lease payment, it is clear that the standby charge under this type of arrangement will be less than the 2 percent per month that is assessed when the Company owns the car. However, for shorter lease terms, the lease payment will be a greater percentage of the capital cost and this relationship may reverse.

Other tax planning techniques would involve any procedure that would reduce the capital cost of purchased cars or the lease payments on leased cars. Such procedures would include high residual values on leasing arrangements and low trade in values assigned to old cars when new ones are purchased. In addition, it might be possible to reduce a taxable benefit, such as the one being allocated to Mr. Stern, by selling his car to a leasing company with an immediate leaseback arrangement. Although large refundable deposits on leasing arrangements would reduce the lease payment and therefore the standby charge, there would be a tax cost to the employer (see Chapter 6).

## Self Study Solution Three - 5

### *Employer Continues To Provide Automobile*

If the employer continues to provide the car, John's only cash outflow will be the taxes assessed on the taxable benefit that results from his having the car available. This outflow under the two Cases would be calculated as follows:

| | Case A $35,000 Cost | Case B $70,000 Cost |
|---|---|---|
| Standby Charge | | |
| [(2%)($35,000)(12)] | $ 8,400 | |
| [(2%)($70,000)(12)] | | $ 16,800 |
| Operating Cost Benefit [(40,000 Kilometers)($0.28)] | 11,200 | 11,200 |
| Total Annual Benefit | $19,600 | $28,000 |
| Number Of Years | 2 | 2 |
| Total Benefit | $39,200 | $56,000 |
| John's Marginal Tax Rate | 48% | 48% |
| Total Taxes On Taxable Benefit | $18,816 | $26,880 |

Note that, because John's use of the car is not primarily (more than 50 percent) for employment purposes, he cannot use the alternative one-half of standby charge calculation of the operating cost benefit.

### *John Purchases The Automobile*

If John purchases the car and pays his own operating costs, the total cash outflow in both Cases would be calculated as follows:

| | |
|---|---|
| Purchase Price | $20,000 |
| Estimated Resale Value | ( 12,000) |
| Operating Costs [(2)(40,000 Kilometers)($0.20)] | 16,000 |
| Total Cash Outflow | $24,000 |

### *Conclusion - Case A ($35,000)*

On the basis of non-discounted cash flows, the best alternative would be to have John's employer continue to provide him with the car. If the cash flows were discounted, the results would be even more favourable for this alternative.

### *Conclusion - Case B ($70,000)*

Since the original cost of the car was $70,000, on the basis of non-discounted cash flows, the best alternative would be to have John purchase the car since the taxable benefit is so high.

Although the requirements of the problem ask that only the cash flows be considered, we would note that the alternative of purchasing the car carries more uncertainty. Both the resale value and the actual operating costs are estimates. If there was a large variation from the estimate for either or both of these amounts, it could substantially affect the total cash outflow of the purchase alternative.

## Self Study Solution Three - 6

### *Approach*

The appropriate comparison in evaluating the interest free loan arrangement would be to determine the cost to the Company of providing the loan and then compare this amount with the cost of providing an equivalent benefit in the form of straight salary. The following analysis calculates the Company's lowest cost route to providing Mr. Malone with the financing required, assuming he is not a shareholder.

### *Cost Of Providing For Interest Payments On Commercial Loan*

As the problem indicates, Mr. Malone can borrow on a loan at a rate of interest of 5 percent. This means that the annual interest payments on $200,000 would amount to $10,000. If the interest is deductible, the after tax cost of this interest would be reduced to $4,900 [($10,000)(1 - .51)].

Mr. Malone is in the 51 percent tax bracket and, if the interest is not deductible, $20,408 [$10,000 ÷ (1 - .51)] of before tax salary would be required to provide the necessary $10,000 in after tax funds. If the interest is deductible, the Company will only have to provide for the $4,900 after tax cost of the loan to Mr. Malone, an amount of $10,000 [$4,900 ÷ (1 - .51)]. The annual cost to the Company of providing for this alternative under both assumptions would be as follows:

| | Not Deductible | Deductible |
|---|---|---|
| Gross Salary Increase [$10,000 ÷ (1 - .51)] | $20,408 | |
| Gross Salary Increase [$4,900 ÷ (1 - .51)] | | $10,000 |
| Reduction In Corporate Taxes | | |
| [(25%)($20,408)] | ( 5,102) | |
| [(25%)($10,000)] | | ( 2,500) |
| Net Cost To Company - Additional Salary | $15,306 | $ 7,500 |

### *Cost Of Providing Interest Free Loan*

Mr. Malone would be assessed a taxable benefit on the loan in the amount of imputed interest at the Regulation 4301 rate. The benefit would amount to $4,000 [(2%)($200,000)] for one year. In order to make the two alternatives comparable, if the interest is not deductible, it is necessary to recognize that Mr. Malone would pay an additional $2,040 [(51%)($4,000)] in taxes on this benefit and, as a consequence, the Company would have to pay him an additional $4,163 [$2,040 ÷ (1 - .51)] in salary to provide for this outflow of funds.

If the interest is deductible, the imputed interest would be deemed interest paid. As he is using all of the funds provided to produce investment income, the full amount would be deductible, resulting in no net change in taxes. If this is the case, this alternative only requires looking at the cost of the loan to the company.

The annual cost to the Company of the loan alternative under both assumptions can be calculated as follows:

| | Not Deductible | Deductible |
|---|---|---|
| Gross Salary Increase [$2,040 ÷ (1 - .51)] | $ 4,163 | N/A |
| Reduction In Corporate Taxes [(25%)($4,163)] | ( 1,041) | N/A |
| Lost Earnings On Funds Loaned [(18%)($200,000)] | 36,000 | $36,000 |
| Corporate Taxes On Imputed Earnings | | |
| [(25%)($36,000)] | ( 9,000) | ( 9,000) |
| Net Cost To Company - Loan | $30,122 | $27,000 |

### *Conclusion*

On the basis of the preceding analysis, it can be concluded that the Company should provide additional salary rather than providing Mr. Malone with an interest free loan of $200,000

whether or not his interest is deductible. This alternative results in a net annual cost to the Company which is either $14,816 ($30,122- $15,306) or $19,500 ($27,000 - $7,500) lower. Given the very high earnings rate on funds used by Technocratic, this result is not unexpected.

## Self Study Solution Three - 7

### *Case A*

**2017** In 2017, the year in which the options are issued, there would be no tax consequences for Ms. Wu.

**2018** The tax consequences in 2018 would be as follows:

| | |
|---|---|
| Fair Market Value At Exercise [(12,000)($31)] | $372,000 |
| Cost Of Shares [(12,000)($22)] | ( 264,000) |
| Employment Income Inclusion<br>= Increase In **Net Income For Tax Purposes** | $108,000 |
| Deduction Under ITA 110(1)(d) [(1/2)($108,000)] | ( 54,000) |
| Increase In **Taxable Income** | $ 54,000 |

**2019** When the shares are sold in 2019, the tax consequences would be as follows:

| | |
|---|---|
| Proceeds Of Disposition [(12,000)($28)] | $336,000 |
| Adjusted Cost Base [(12,000)($31)] | ( 372,000) |
| Capital Loss | ($ 36,000) |
| Inclusion Rate | 1/2 |
| Allowable Capital Loss | ($ 18,000) |

Ms. Wu will only be able to deduct this loss in 2019 to the extent that she has taxable capital gains on other dispositions.

### *Case B*

**2017** There are no tax consequences in 2017.

**2018** There are no tax consequences in 2018.

**2019** In 2019, the employment income inclusion would be as follows:

| | |
|---|---|
| Fair Market Value At Exercise [(12,000)($31)] | $372,000 |
| Cost Of Shares [(12,000)($22)] | ( 264,000) |
| Employment Income Inclusion<br>= Increase In **Net Income For Tax Purposes** | $108,000 |
| Deduction Under ITA 110(1)(d) [(1/2($108,000)] | ( 54,000) |
| Increase In **Taxable Income** | $ 54,000 |

In addition, there would be an allowable capital loss calculated as follows:

| | |
|---|---|
| Proceeds Of Disposition [(12,000)($28)] | $336,000 |
| Adjusted Cost Base [(12,000)($31)] | ( 372,000) |
| Capital Loss | ($ 36,000) |
| Inclusion Rate | 1/2 |
| Allowable Capital Loss | ($ 18,000) |

Ms. Wu will only be able to deduct this loss in 2019 to the extent that she has taxable capital gains on other dispositions.

## Self Study Solution Three - 8

### Part A

There would be no tax effects resulting from the granting of the options in 2017.

Since the option price was below the fair market value at the time the shares were issued, there is no deduction available under ITA 110(1)(d) in the calculation of Taxable Income. As Patricia's employer is a public company, the exercise of the options in 2018 will result in the following addition to Net Income For Tax Purposes and Taxable Income:

| | |
|---|---|
| Fair Market Value At Exercise [(1,500)($50)] | $75,000 |
| Option Price [(1,500)($45)] | ( 67,500) |
| Employment Income (Increase In **Net** And **Taxable Income** | $ 7,500 |

In 2019, when the shares are sold, there is the following addition to **Net Income For Tax Purposes** and **Taxable Income**:

| | |
|---|---|
| Proceeds Of Disposition [(1,500)($55)] | $82,500 |
| Adjusted Cost Base [(1,500)($50)] | ( 75,000) |
| Capital Gain | $ 7,500 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain | $ 3,750 |

### Part B

There would be no tax effects resulting from the granting of the options in 2017.

If the 2017 trading value for the shares had been $44, the option price would have been above fair market value and the ITA 110(1)(d) deduction would be available. On this basis, the 2018 results would be as follows:

| | |
|---|---|
| Fair Market Value At Exercise [(1,500)($50)] | $75,000 |
| Option Price [(1,500)($45)] | ( 67,500) |
| Employment Income | |
| Increase In **Net Income For Tax Purposes** | $ 7,500 |
| ITA 110(1)(d) Deduction [(1/2)($7,500)] | ( 3,750) |
| Increase In **Taxable Income** | $ 3,750 |

The results for 2019 would be unchanged from Part A.

### Part C

If Patricia's employer had been a Canadian controlled private company, there would be no tax effects in either 2017 or 2018.

There is no deduction available under either ITA 110(1)(d) or ITA 110(1)(d.1) when the shares are sold. The option price was below the fair market value when the options were issued. Further, Patricia did not hold the shares for the two years required for the ITA 110(1)(d.1) deduction. When the shares are sold in 2019, there is the following addition to Net Income For Tax Purposes and Taxable Income:

| | |
|---|---|
| Fair Market Value At Exercise [(1,500)($50)] | $75,000 |
| Option Price [(1,500)($45)] | ( 67,500) |
| Taxable Capital Gain [(1/2)(1,500)($55 - $50)] | 3,750 |
| Increase In **Net Income For Tax Purposes** And **Taxable Income** | $11,250 |

## Self Study Solution Three - 9

| | | |
|---|---|---|
| Salary From Maritime Trust [(6/12)($105,000)] | | $ 52,500 |
| Salary From Bolten [(6/12)($90,000)] | | 45,000 |
| Total Salaries | | $ 97,500 |
| Maritime Trust Stock Options (Note 1): | | |
| Market Price Of Shares [(5,000)($16)] | $80,000 | |
| Option Price [(5,000)($15)] | ( 75,000) | 5,000 |
| Bolten Financial Services Stock Options (Note 1) | | Nil |
| Automobile Benefit (Note 2): | | |
| Standby Charge [(2%)($40,000)(4)(6,668/6,668)] | $3,200 | |
| Operating Cost Benefit - Lesser Of: | | |
| • [(10,000)($0.28)] = $2,800 | | |
| • [(1/2)($3,200)] = $1,600 | 1,600 | 4,800 |
| Loan Benefit (Note 3) | | 2,000 |
| Net Employment Income | | $109,300 |

**Notes:**

1. As Bolten Financial Services is a Canadian controlled private corporation, the exercise of the option to purchase its common stock does not result in a taxable benefit at the time of exercise. Since Maritime Trust Inc. is a public company, the exercise of the option to purchase its common stock does result in a taxable benefit at the time of exercise. Mr. Jurgens has a stock option deduction equal to $2,500 [(1/2)($5,000)] under ITA 110(1)(d) created by the exercise of the Maritime Trust stock option. However, the stock option deduction would reduce Taxable Income and would not affect net employment income. The Bolten stock option income inclusion of $2,000 [(1,000)($22 - $20)] and deduction of $1,000 [(1/2)($2,000)] are both deferred until the shares are sold.

2. As Mr. Jurgens' employment related milage is more than 50 percent of the total milage, he can make use of the reduced standby charge formula. In this case, however, his personal usage exceeded the 6,668 [(4)(1,667)] kilometer maximum usage allowed by the reduction, so the reduction is nil. His employment related milage is more than 50 percent of the total and, as a consequence, he can elect to calculate the operating cost benefit as one-half of the standby charge. Since this is less than the amount determined through the usual calculation, it would be the operating cost benefit.

3. The imputed interest on the interest free loan must be included in employment income under the requirements of ITA 6(9), a benefit which is defined in ITA 80.4(1). The amount of the benefit is $2,000 [(2%)($200,000)(6/12)]. Note that there is a deduction under ITA 110(1)(j) for the amount of this benefit which relates to an interest free home relocation loan of $25,000. However, this is a deduction in the calculation of Taxable Income and will not affect the amount of net employment income.

4. The interest and dividend income is not included in the calculation of net employment income.

## Self Study Solution Three - 10

Ms. Kline's net employment income for the year would be calculated as follows:

| | |
|---|---|
| Gross Salary | $73,500 |
| Registered Pension Plan Contributions | ( 2,400) |
| Automobile Benefit (Note One) | 270 |
| Contributions To Group Disability Plan (Note Two) | Nil |
| Disability Insurance Benefit (Note Two) | 1,400 |
| Professional Dues | ( 1,650) |
| Stock Option Benefit [(200)($70 - $50)] (Note Three) | 4,000 |
| Net Employment Income | $75,120 |

**Note One** Based on the fact that Ms. Kline's employment related usage is more than 50 percent of total usage, the automobile benefit is calculated as follows:

| | |
|---|---|
| Standby Charge [(2/3)(11)($700 - $50)(3,000/18,337*)] | $ 780 |
| Operating Cost Benefit - Lesser Of: | |
| • [(3,000)($0.28)] = $840 | |
| • [(1/2)($780)] = $390 | 390 |
| Total Before Payments | $1,170 |
| Payments For Personal Use [(3,000)($0.30)] | ( 900) |
| Taxable Benefit | $ 270 |

*[(11)(1,667)]

As Ms. Kline's employment related usage is more than 50 percent, she can elect to use one-half the standby charge as the operating cost benefit.

**Note Two** The contributions to the group disability plan are not deductible, but can be applied against the $1,800 received under the plan during the year. Since the employer's contributions to this plan are not a taxable benefit, the $1,800 in benefits received must be included in employment income. However, this benefit can be reduced by the $400 ($225 + $175) in total contributions that she has made in 2018 and 2019.

**Note Three** Although Ms. Kline would qualify for the deduction of one-half of the stock option benefit under ITA 110(1)(d), it is a deduction from Taxable Income and would not affect the calculation of the required figure in this problem, net employment income.

## Self Study Solution Three - 11

As Ms. Firth paid all of her own operating expenses, there is no taxable benefit for vehicle operating costs. However, she has to include the $7,200 car allowance in income. Given this, she can deduct a pro rata share of her actual expenses. The deduction would be $5,728 [($6,200)(85,000 km ÷ 92,000 km)].

Ms. Firth's total entertainment, meal, and travel expenses that would be deductible under ITA 8(1)(f) are as follows:

| | |
|---|---|
| Entertainment Expenses [(1/2)($6,500)] | $3,250 |
| Travel Meals [(1/2)($1,300)] | 650 |
| Lodging | 3,500 |
| Automobile Operating Costs [($6,200)(85,000 ÷92,000)] | 5,728 |
| Total Salesperson Expenses | $13,128 |

As this total is less than her commission income of $14,000, they can all be deducted under ITA 8(1)(f).

Ms. Firth's net employment income for the year would be calculated as follows:

| | | |
|---|---|---|
| Gross Salary | | $72,000 |
| Commission Income | | 14,000 |
| Additions: | | |
| Disability Insurance Receipts, Less Employee's Premium ($2,000 - $250) | $ 1,750 | |
| Car Allowance | 7,200 | |
| Automobile Benefit (Note 1) | 2,471 | |
| Term Life Insurance Benefit [($1,350)(2/3)] | 900 | |
| Low Interest Loan Benefit [($400,000)(2%) - $3,000] | 5,000 | |
| Gift (Note 2) | Nil | |
| Stock Option Benefit [(1,000)($7 - $5)] (Note 3) | 2,000 | |
| Tennis Club Membership (Note 4) | Nil | |
| Travel Allowance | 3,600 | 22,921 |
| Deductions: | | |
| Registered Pension Plan Contributions (Note 5) | ($ 3,200) | |
| Salesperson Expenses (Preceding Calculation) | ( 13,128) | ( 16,328) |
| Net Employment Income | | $92,593 |

**Note 1** The personal benefit on the company car would be calculated as follows:

| | |
|---|---|
| Reduced Standby Charge [(2%)($58,000)(11)(7,000/18,337*)] | $4,871 |
| Operating Costs Benefit | Nil |
| Total Benefit | $4,871 |
| Less: Payments Withheld By Employer | ( 2,400) |
| Taxable Benefit | $2,471 |

* [(1,667)(11)]

**Note 2** Employers can provide their employees with a non-cash gift with a value of less than $500 without creating a taxable benefit. The mini iPad costs less than $500.

**Note 3** Although Ms. Firth would qualify for the deduction of one-half of the stock option benefit under ITA 110(1)(d), it is a deduction from Taxable Income and would not affect the calculation of net employment income.

**Note 4** The $2,500 membership to the Mountain Tennis Club paid by the Company for Ms. Firth is not a taxable benefit since the primary beneficiary appears to be the Company.

**Note 5** Contributions made to a registered pension plan under the terms of the plan are deductible. The matching contributions made by the employer are not a taxable benefit.

**Other Excluded Items** Other items not included and the reason for their exclusion:

- Federal and provincial income taxes withheld are not deductible.

## Self Study Solution Three - 12

Mr. Jones' net employment income would be calculated as follows:

| | | | |
|---|---|---|---|
| Salary | | | $25,800 |
| Taxable Benefit From Fishing Trip | | | 2,450 |
| Commission Income | | | |
| Sales Commissions | | $47,700 | |
| Deductions: | | | |
| Airline Tickets | ($2,350) | | |
| Office Supplies | ( 415) | | |
| Client Entertainment [(50%)($1,750)] | ( 875) | | |
| CCA (Note 1) | ( 7,560) | | |
| Operating Costs (Note 2) | ( 5,040) | ( 16,240) | 31,460 |
| Net Employment Income | | | $59,710 |

**Note 1** The deductible capital cost allowance on the car would be calculated as follows:

| | |
|---|---|
| Full Capital Cost Allowance* | $10,800 |
| Employment Related Usage Proportion (35,000/50,000) | 70% |
| Deductible Amount | $ 7,560 |

*While this subject is not covered until Chapter 5, the maximum capital cost allowance would be calculated as follows:

$$\$10,800 = [(\$24,000)(30\%)(150\%)]$$

**Note 2** As the car was used 30 percent on personal matters, only $5,040 [(70%)($7,200)] in operating costs would be deductible.

**Other Notes**

- The laptop computer is a capital expenditure and is not deductible as an expense. Since an employee cannot deduct CCA except for an automobile, musical instrument, or aircraft, the purchase of the laptop computer would not have any effect on either employment income or taxes payable.
- The payment for Blue Cross would be eligible for the medical expenses tax credit, but would not be deductible in the calculation of net employment income. The life insurance premiums would not have any effect on either employment income or taxes payable.
- Discounts for employees on merchandise normally sold by an employer are not generally considered to be a taxable benefit.

## Self Study Solution Three - 13

### *Part A*

As Mr. Worthy's income includes commissions, he has a choice of deducting his expenses under a combination of ITA 8(1)(f), (i), and (j) or, alternatively under a combination of ITA 8(1)(h), (h.1), (i), and (j).

Deductions under ITA 8(1)(f) are limited to the amount of commissions earned. Alternatively, traveling costs and motor vehicle costs other than capital costs can be deducted under ITA 8(1)(h) and ITA 8(1)(h.1). Deductions under these provisions are not limited to commission

income. As discussed in the text, he cannot use both ITA 8(1)(f) and the combination of ITA 8(1)(h) and (h.1).

As the deduction under ITA 8(1)(f) is limited by commission income, alternative calculations are required to determine the maximum deduction. In the calculations which follow, we have minimized the effect of the commission income limit by listing any item that can be deducted under either ITA 8(1)(f) or ITA 8(1)(i) or (j) under the ITA 8(1)(i) and (j) column.

For example, house utilities and maintenance could be deducted under either ITA 8(1)(f) or 8(1)(i). We have included them under ITA 8(1)(i) in order to minimize the deductions that are limited by commission income.

The required calculations are as follows:

| | ITA 8(1)(f) (Limited To $11,000) | ITA 8(1) (h) and (h.1) | ITA 8(1) (i) and (j) |
|---|---|---|---|
| Work Space In The Home Costs | | | |
| Monthly Charge For Residential Line | - | - | - |
| Long Distance Telephone Charges | - | - | $ 400 |
| Cellular Phone Airtime | - | - | 800 |
| Office Supplies | - | - | 295 |
| House Utilities | - | - | 485 |
| House Maintenance | - | - | 255 |
| House Insurance | $ 70 | - | - |
| Property Taxes | 265 | - | - |
| Capital Cost Allowance - House | - | - | - |
| Mortgage Interest | - | - | - |
| Automobile Costs: | | | |
| Operating Costs [(80%)($2,700)] | 2,160 | 2,160 | - |
| Car Interest [(80%)($2,300)] | - | - | 1,840 |
| Car CCA [(80%)($2,450)] | - | - | 1,960 |
| Entertainment | | | |
| Deductible Portion [(50%)($2,550)] | 1,275 | - | - |
| Travel Costs | | | |
| Hotels | 2,850 | $2,850 | - |
| Deductible Portion Of Meals [(50%)($900)] | 450 | 450 | - |
| Office Furniture | | | |
| Interest | - | - | - |
| Capital Cost Allowance | - | - | - |
| Total | $7,070 | $5,460 | $6,035 |

Using the preceding calculations, Mr. Worthy's minimum net employment income can be calculated as follows:

| | | |
|---|---|---|
| Salary | | $65,000 |
| Commissions | $11,000 | |
| Expenses Under ITA 8(1)(f) - Limited To Commissions | ( 7,070) | 3,930 |
| Total | | $68,930 |
| Expenses Under ITA 8(1)(i) and (j) | | ( 6,035) |
| Net Employment Income | | $62,895 |

Expenses in excess of commission income cannot be deducted under ITA 8(1)(f). Since the total of the expenses is less than the commissions of $11,000, they can all be deducted. The

deduction of automobile capital costs (CCA and financing costs) under ITA 8(1)(j) is permitted without regard to other provisions used.

**Notes:**

1. The monthly telephone charge is not deductible. The long distance charges and cellular telephone airtime to clients can be deducted. The deduction for supplies can be deducted under ITA 8(1)(f) or (i). They have been deducted under ITA 8(1)(i), which is not limited by the commission income.
2. Only 50 percent of entertainment and meals when traveling are deductible.
3. ITA 8(1)(f) prohibits the deduction of amounts associated with capital assets except as they are permitted under ITA 8(1)(j) and ITA 8(1)(p). These latter Paragraphs only permit interest or capital cost allowance to be deducted when it is related to an automobile, aircraft, or musical instrument. Therefore, the interest and the capital cost allowance on the house and the office furniture would not be deductible against employment income. This is a good illustration of the importance of distinguishing between employment income and business income. While these amounts cannot be deducted against employment income, they would likely be deductible against business income.
4. As the car is used 20 percent for personal purposes, this proportion of the operating costs, capital cost allowance, and interest costs will not be deductible.
5. The deduction for work space in the home costs has been split between ITA 8(1)(i) and (f). Since the maintenance portion can be deducted under ITA 8(1)(i) by any employee, it is not limited by the commission income. The insurance and property tax components are limited as they can only be deducted under ITA 8(1)(f). A limitation, which is not illustrated in this problem, prevents the deduction of work space in the home costs from creating an employment loss. If any of these costs had not been deductible during the current year, they could be deducted against employment income in any subsequent year as long as a loss is not created or increased by their deduction.
6. Mr. Worthy's employer must sign Form T2200 certifying that Mr. Worthy is required to incur travel expenses and maintain his own work space. Mr. Worthy must retain this signed form with his records in order to deduct car and home office expenses.

### *Part B*

If Mr. Worthy deducted the ITA 8(1)(f) expenses, they would be limited to his commission income of $4,000. Alternatively, he can use the combination of ITA 8(1)(h) and (h.1). His minimum net employment income under both alternatives can be calculated as follows:

| | ITA 8(1)(f) | ITA 8(1)(h)(h.1) |
|---|---|---|
| Salary | $65,000 | $65,000 |
| Commissions | 4,000 | 4,000 |
| Expenses Under ITA 8(1)(f) - Limited To Commissions | ( 4,000) | Nil |
| Subtotal | $65,000 | $69,000 |
| Expenses Under ITA 8(1)(h) and (h.1) | Nil | ( 5,460) |
| Expenses Under ITA 8(1)(i) and (j) | ( 6,035) | ( 6,035) |
| Net Employment Income | $58,965 | $57,505 |

Using the combination of ITA 8(1)(h), (h.1), (i), and (j) produces a lower net employment income figure. Note that when this approach is used, work space in the home costs are limited to utilities and maintenance. Further, there is no deduction for entertainment costs. However, this approach results in deductions totalling $1,460 ($5,460 - $4,000) more than the amount available using ITA 8(1)(f), (i), and (j) due to the effect of the commission income limit.

## Self Study Solution Three - 14

Mitch Lesner's net employment income would be calculated as follows;

| | |
|---|---|
| Item 1 - Signing Bonus (Note 1) | $10,000 |
| Item 1 - Salary Received (Note 1) | 62,550 |
| Item 1 - RPP Contributions Withheld | ( 1,200) |
| Item 1 - Other Items (Note 1) | Nil |
| Item 2 - Bonus Received (Note 2) | 2,000 |
| Item 3 - Counseling Services (Note 3) | Nil |
| Item 4 - Group Medical Coverage (Note 4) | Nil |
| Item 5 - Employer Contribution To RPP (Note 5) | Nil |
| Item 6 - Professional Dues Paid (Note 6) | ( 785) |
| Item 6 - Employer Reimbursement Of Professional Dues (Note 6) | 628 |
| Item 7 - Wedding Gifts (Note 7) | Nil |
| Item 8 - Squash Club Membership (Note 8) | Nil |
| Item 9 - Housing Loss Reimbursement (Note 9) | 1,300 |
| Item 10 - Imputed Interest On Housing Loan (Note 10) | 170 |
| Item 11 - Stock Option Benefit (Note 11) | 1,280 |
| Item 12 - Automobile Benefit (Note 12) | 741 |
| Item 13 - Stationery And Supplies | ( 129) |
| Item 13 - Long Distance Calls | ( 74) |
| Item 13 - Home Office (Note 13) | ( 563) |
| Item 14 - Home Office Allowance (Note 14) | 1,500 |
| Net Employment Income | $77,418 |

**Note 1** Amounts received prior to, during or after employment are required to be included in employment income when received.

Salary and other forms of remuneration such as bonuses are included in income when received regardless of when earned.

Income taxes, CPP and EI withheld are not deductible. Note, however, that the CPP and EI are eligible for a non-refundable tax credit that will reduce Tax Payable.

**Note 2** Only the $2,000 amount of the bonus that was received in 2019 will be included in that year's Net Income For Tax Purposes. The remaining $5,450 will not be included in Net Income For Tax Purposes until it is received in 2020.

**Note 3** Employer provided mental health counseling services are not considered to be a taxable benefit.

**Note 4** Group medical plans are generally referred to as Private Health Insurance Plans. Employer paid premiums for such plans are not considered to be a taxable benefit.

**Note 5** Employer contributions to RPPs are not considered to be a taxable benefit.

**Note 6** The reimbursement of employee professional dues is considered a taxable benefit, but the employee is generally entitled to an employment expense deduction for annual professional membership dues under ITA 8(1)(i).

**Note 7** Non-cash gifts from employers that total less than $500 per year are not considered taxable benefits. The employer's share of the wedding gifts was $425.

**Note 8** Fees for club memberships where the primary advantage is to the employer are not considered to be a taxable benefit.

**Note 9** Employer-reimbursed housing losses fall into two categories – regular housing losses and eligible housing losses. Eligible housing losses occur when there is

an eligible relocation which generally means a relocation or move the expenses of which would qualify for a moving expense deduction had they been paid by the employee. In this case the move is an eligible relocation meaning that the reimbursement qualifies as an eligible housing loss. The employer reimbursed $17,600 [(80%)($22,000)]. The taxable portion of the loss reimbursement is $1,300 [(1/2)($17,600 - $15,000)]. The remaining tax free amount of $16,300 can be calculated as ($17,600 - $1,300) or [$15,000 + (1/2)($17,600 - $15,000)].

**Note 10** When an employee receives an interest-free or low interest loan an imputed interest benefit is calculated. The interest benefit is $170 [(1%)($200,000)(31/365)]. Note that the alternative calculation, based on months outstanding, would result in a value of $167 [(1%)($200,000) ÷ 12]. It appears that this value would be accepted by the CRA.

There is no reduction in that amount since Mitch is not required to repay any of the interest. As this loan would qualify as a home relocation loan, Mitch will claim a home relocation loan deduction in the calculation of Taxable Income. However, this would have no effect on the required net employment income calculation.

**Note 11** Despite the fact that the option price was 20 percent below fair market value, the issuance of the stock options does not create employment income. However, when he exercises the option by purchasing shares, there is a benefit as follows:

| | |
|---|---|
| Market Value At Exercise Date ($12,800 ÷ 80%) | $16,000 |
| Option Price | ( 12,800) |
| Value of Benefit (200 Shares) | $ 3,200 |
| Per Share Benefit ($3,200 ÷ 200) | $16 Per Share |

As Oxford Associates is a CCPC, this benefit can be deferred until the shares are sold. As 80 shares are sold, there will be a 2019 net employment income inclusion of $1,280 [(80)($16)]. Note that, while this is not relevant to the determination of net employment income, no deduction would be available under either ITA 110(1)(d) or 110(1)(d.1) as the option price will always be less than the fair market value at the time the option was granted.

In addition to the employment income inclusion, there is a taxable capital gain of $1,280 {[1/2][$8,960 - (80/200)($16,000)]}. However, capital gains are not a component of net employment income.

**Note 12** The kilometers driven in the year total 19,252 (19,414 – 162), of which 5,198 are personal and 14,054 (19,252 - 5,198) are employment related. Since the employment related driving accounts for more than 50 percent (14,054 ÷ 19,252 = 73%), a reduced standby charge is available. The automobile benefit would be calculated as follows:

| | |
|---|---|
| Standby Charge [(2/3)(8)($430)(5,198 ÷ 13,336*)] | $ 894 |
| Operating Cost Benefit - Lesser Of: | |
| • [($0.28)(5,198)] = $1,455 | |
| • [(1/2)($894) = $447 | 447 |
| Total Benefit | $1,341 |
| Reimbursement To Employer [(8)($75)] | ( 600) |
| Net Benefit | $ 741 |

*[(8)(1,667)]

**Note 13** Based on floor space, the home office occupies 8.5 percent of the apartment [100 ÷ 1,176]. The work space in the home expenses that may be claimed for the period June 1 to November 30 are the following:

| | |
|---|---|
| Rent Paid [(6)($960)] | $5,760 |
| Electricity Paid [($870)(6 ÷ 8.5 Months)] | 614 |
| Paint | 253 |
| Total Eligible Expenses | $6,627 |
| Home Office Use | 8.5% |
| Deductible Expense | $ 563 |

**Note 14** Allowances received are included in employment income unless the allowance is specifically excluded by ITA 6(1)(b). There is no exclusion for this allowance. The amount is $1,500 [(6)($250)].

## Chapter 3 Learning Objectives

After completing Chapter 3, you should be able to:

1. Explain the basic concept of employment income (paragraph [P hereafter] 3-1 to 3-6).
2. Explain the reasons for using, and rules associated with, bonus arrangements for employees (P 3-7 to 3-13).
3. Distinguish between an employee and a self-employed individual earning business income and list the advantages and disadvantages of both classifications (P 3-14 to 3-44).
4. Explain how salaries and fringe benefits in general are taxed (P 3-45 to 3-55).
5. List the benefits that can be excluded from employment income under ITA 6(1)(a) and the benefits that must be included in income under the other Paragraphs in ITA 6(1) (P 3-56 to 3-59).

6. Apply the content of IT Folio S2-F3-C2 or the CRA Employers' Guide with respect to the tax status of the various employee benefits described within the publications (P 3-60 to 3-63).
7. Explain the basic elements of tax planning for employee benefits (P 3-64 to 3-76).
8. Describe the effects of GST/HST/PST on taxable benefits (P 3-77 and 3-78).
9. Calculate the standby charge and operating cost benefits that apply to employees who are provided with an automobile that is leased or owned by their employer (P 3-79 to 3-122).

10. Explain basic tax planning for company cars (P 3-123 and 3-124).
11. Explain the tax treatment of allowances that are provided by employers to their employees for travel costs (P 3-125 to 3-142).
12. Describe the tax status of various types of insurance benefits that are provided by employers to their employees (P 3-143 to 3-148).
13. Calculate the tax consequences of low-rate or interest free loans to employees (P 3-149 to 3-156).
14. Calculate the tax consequences that result from employees receiving and exercising stock options, and from the subsequent sale of the acquired shares (P 3-157 to 3-176).

15. List and describe other inclusions in employment income (P 3-177 to 3-185).
16. List and describe specific deductions against employment income that are listed in ITA 8 (P 3-186 to 3-206).
17. Explain how deductible work space in the home costs for employees are calculated (P 3-207 to 3-212).

# CHAPTER 4

## How To Work Through Chapter 4

We recommend the following approach in dealing with the material in this chapter:

**Taxable Income Of Individuals**

- Read the beginning of the Chapter to paragraph 4-9 (in the textbook).

**Federal And Provincial Tax Payable Before Credits**

- Read paragraph 4-10 to 4-22.
- Do Exercise Four-1 and check the solution in this Study Guide.
- Read paragraph 4-23 to 4-27.

**Credits Against Tax Payable - Calculating The Amount**

- Read paragraph 4-28 to 4-32.

**Spousal, Eligible Dependant And Canada Caregiver For Child Tax Credits**

- Read paragraph 4-33 to 4-38.
- Do Exercise Four-2 and check the solution in this Study Guide.
- Do Self Study Problem Four-1 which is available on MyLab and check the solution in this Study Guide.
- Read paragraph 4-39 to 4-48.

**Basic Personal And Caregiver Tax Credits**

- Read paragraph 4-49 to 4-59.
- Do Exercises Four-3 to Four-5 and check the solutions in this Study Guide.
- Read paragraph 4-60 and 4-61.
- Do Exercise Four-6 and check the solution in this Study Guide.

**Age, Pension, Canada Employment And Adoption Expenses Tax Credits**

- Read paragraph 4-62 and 4-63.
- Do Exercise Four-7 and check the solution in this Study Guide.
- Read paragraph 4-64 to 4-76.
- Do Exercise Four-8 and check the solution in this Study Guide.

**Digital News Subscriptions Credit**

- Read paragraph 4-77 to 4-78.

**Home Accessibility Tax Credit**

- Read paragraph 4-79 to 4-89.
- Do Exercise Four-9 and check the solution in this Study Guide.

**First Time Home Buyer's And
Volunteer Firefighters And Search And Rescue Workers Tax Credits**

- Read paragraph 4-90 to 4-96.

**Charitable Donations Credit**

- Read paragraph 4-97 to 4-104.
- Do Exercise Four-10 and check the solution in this Study Guide.
- Read paragraph 4-105 to 4-108.
- Do Exercise Four-11 and check the solution in this Study Guide.

**Medical Expense Credit**

- Read paragraph 4-109 to 4-119.
- Do Exercise Four-12 and check the solution in this Study Guide.

**Disability Credit**

- Read paragraph 4-120 to 4-127.
- Do Exercise Four-13 and check the solution in this Study Guide.
- Read paragraph 4-128 to 4-130.

**Education Related Credits Including Carry Forwards And Transfers**

- Read paragraph 4-131 to 4-138.
- Do Exercise Four-14 and check the solution in this Study Guide.
- Read paragraph 4-139 to 4-148.
- Do Exercise Four-15 and check the solution in this Study Guide.

**Employment Insurance And Canada Pension Plan Tax Credits**

- Read paragraph 4-149 to 4-155.

**Credit Transfers To A Spouse Or Common-Law Partner**

- Read paragraph 4-156 to 4-158.
- Do Exercise Four-16 and check the solution in this Study Guide.
- Do Self Study Problems Four-2 and Four-3 and check the solutions in this Study Guide.

**Political Contributions Credit**

- Read paragraph 4-159 to 4-161.
- Do Exercise Four-17 and check the solution in this Study Guide.

**Labour Sponsored Venture Capital Corporation (LSVCC) Credit**

- Read paragraph 4-163 to 4-167.
- Do Self Study Problems Four-4 and Four-5 and check the solutions in this Study Guide.

**Refundable Credits - GST And Refundable Medical Expense Supplement**

- Read paragraph 4-168 to 4-179.
- Do Exercise Four-18 and check the solution in this Study Guide.

**Refundable Credits - Canada Workers Benefit And Teacher School Supply**

- Read paragraph 4-180 to 4-186.

**Refundable Credits - Climate Action Incentive Payments**

- Read paragraph 4-187 to 4-194.

**Refundable Credits - Canada Training Credit (Proposed)**

- Read paragraph 4-195 to 4-201.

**EI And OAS Repayment (Clawback)**

- Read paragraph 4-202 to 4-212.
- Do Exercise Four-19 and check the solution in this Study Guide.

**Comprehensive Example**

- Read paragraph 4-213.
- Do Self Study Problems Four-6 to Four-8 and check the solutions in this Study Guide.

### Sample Personal Tax Return For Chapter 4

- Read the Sample Personal Tax Return For Chapter 4 found in this Chapter of this Study Guide. The complete tax returns are available on MyLab in two formats, a T1 ProFile return file and a .PDF file.

### Tax Software Self Study Problem

- Read the Suggestions For Working With ProFile Software found in this Chapter of this Study Guide.
- Do Tax Software Self Study Problem - Chapter 4 using the ProFile T1 Software. The Self Study Problem is found in this Chapter of this Study Guide. The complete tax return is available on MyLab.

### To Complete This Chapter

- If you would like more practice in problem solving, do the Supplementary Self Study Problems for the chapter. These problems and solutions are available on MyLab.
- Review the Key Terms Used In This Chapter in the textbook at the end of Chapter 4. Consult the Glossary for the meaning of any key terms you do not know.
- Test yourself with the Chapter 4 Glossary Flashcards available on MyLab.
- Ensure you have achieved the Chapter 4 Learning Objectives listed in this Study Guide.
- As a review, we recommend you view the PowerPoint presentation for Chapter 4 that is on MyLab.

### Practice Examination

- Write the Practice Examination for Chapter 4 that is on MyLab. Mark your examination using the Practice Examination Solution that is also on MyLab.

## Sample Personal Tax Return For Chapter 4

The following example contains a T1 individual income tax returns completed using the ProFile T1 Personal Income Tax Program for 2018 tax returns from Intuit Canada. As software for 2019 is not yet available, this example contains 2018 rates and credits.

The updated 2019 filing version of the ProFile software will be available in January, 2020. Non-filing versions will be available prior to that date, but include a number of 2019 draft forms that have not yet been updated. On installation, the program defaults to check for updates, so non-filing versions may be installed automatically. In January, 2020, after the first 2019 filing version is released, the updated 2019 version of this sample return will be available on MyLab at:

**http://www.pearsonmylabandmastering.com**

This example is expanded in Chapter 11 to contain other components of Taxable Income and Tax Payable. In the following example, the relevant T1 schedule or ProFile form name is provided in square brackets to make it easier for users to find where the information is input.

## Sample Files On MyLab

***To View The Tax Return Files***

The complete sample tax returns are available on MyLab in two versions, a T1 ProFile return file and a .PDF file.

To view the ProFile return files (files with a .18T extension), you must have the ProFile program installed. For information on how to obtain the program for free, see MyLab.

To view the .PDF files, you must have the Adobe Reader program installed. This program can be installed for free from the Adobe website (www.adobe.com).

***Tips To Increase The Benefits From Viewing The ProFile Files***

When viewing the sample return ProFile file, we suggest the following:

- Press <F1> on any ProFile form or field to display related information in the help system. In ProFile dialog boxes, click the [?] symbol in the top right corner, then click any element for help on that item.
- By pressing <F4> you will open the Form Explorer. In the categories of forms appearing in the shaded box on the left, if you choose "A. Used" near the bottom of the column, all the forms that have calculations for the return will be shown. You can then double click on the form itself to view it.
- Right clicking on a number in a field shows a variety of options, including the form or schedule where the amount originated from.
- Clicking on "Show Auditor" under the "Audit" list will display any warnings or potential errors.

For students who would like more assistance in using the software, we have provided "Suggestions For Working With ProFile Software" in this Study Guide following this example.

## Sample T1 Tax Return Data

**DISCLAIMER:** All characters appearing in this example are fictitious. Any resemblance to real persons, living or dead, is purely coincidental.

George Pilot (SIN 527-000-145) is a married, semi-retired air force pilot living in Banff, Alberta. His wife, Deborah (SIN 130-692-544) was mauled by a grizzly bear while hiking 3 years ago. The attack left her blind and limited her mobility. [Schedule 2 - Yes to disability amount]

They have been your clients for many years. George was born on February 24, 1967 and Deborah was born on April 10, 1971. They are both Canadian citizens.

After some discussion with George and Deborah, you confirm that they have never owned any foreign property. They both authorize the CRA to provide information to Elections Canada and authorize you to e-file their returns. They are currently living at 69 BBB Street in Banff, Alberta T9Z 0C0. Their home phone number is (403) 111-1111.

George and Deborah have three children who are all in good health:

- Bryan (SIN 527-000-947) was born on March 12, 2011 and had no income during the year.
- Janice (SIN 527-000-269) was born on June 6, 2005 and is in high school. She had income from babysitting totalling $400 during 2018.
- Willa (SIN 527-000-228) was born on January 22, 1999 and is attending university in Edmonton. Willa had Net Income of $3,300 during 2018.

George has a passion for flying and was hired in February to fly fire bombers June 1 to September 30 for the provincial forest service fire control squad located in Banff.

George informs you that on February 12, 2018, he received $2 million from his mother's estate. Using some of these funds, George bought a house in Banff. The remainder of the funds were invested with his stockbroker, $$$$ Inc. In this Chapter 4 version of the example, assume there is no investment income from these funds.

Deborah had no income during the year. [Info - Spousal information - Yes to the question "Is spouse's Net Income zero?"]

George brings you the following receipts and documents:

1. A T4 (included in this example).
2. A T2202A "Tuition And Enrollment Certificate" for himself from Athabasca University. It showed he was a part time student for 6 months and paid $591 in tuition for 2018. [T2202]
3. Two charitable donation receipts. One in George's name for $1,000 from the Canadian Wildlife Federation dated April 10, 2018. A second receipt in Deborah's name for $100 from the Canadian National Institute for the Blind (CNIB) dated December 3, 2018. [Donations]
4. A statement from the Banff Dental Clinic that George paid a total of $1,650 during 2018. This consisted of $850 for himself on November 24, and $200 each for Deborah, Bryan, Willa and Janice on December 15. [Medical]
5. An invoice from the CNIB in Deborah's name for $375 dated December 26, 2018 for computer peripherals designed exclusively for a person who is blind to use a computer. She had obtained a prescription from her doctor specifying her need for this equipment. [Medical]
6. George spent $14,700 during 2018 on various permanent modifications to the house. His goal for these changes was to allow Deborah to be more mobile inside and outside the house (ex., outside ramps and railings in the halls and stairways) and to reduce the risk of harm to her (a walk-in bathtub). George has detailed invoices for the renovations. Since Deborah's mobility impairment is not severe, these expenditures do not qualify as allowable medical expenses. [Schedule 12]
7. An agreement of purchase and sale for a house at 69 BBB St. in Banff. The purchase price was $800,000 and the invoice for legal fees totalled $1,200. The deal closed March 31, 2018 and George paid the purchase price of the house in cash. George and his family had been living in a rented townhouse for the last 5 years. Prior to that George had owned a house, but it went to his ex-wife in the divorce settlement. Deborah has never owned a principal residence. [OtherCredits for the Home Buyers' Credit.]
8. An instalment statement for 2018 that showed that George had paid the CRA instalments of $1,500 on September 14 and December 14 ($3,000 in total). These were the instalments requested by the CRA for the year due to his self-employed income in the previous year. [OtherCredits]

## Sample T1 Tax Return Notes

### *General Notes*

- Inheritances are not taxable.
- Due to his low Net Income For Tax Purposes, George is eligible for the refundable medical expense supplement and the Canada Workers Benefit.
- Although George could consider carrying forward his medical expenses because his non-refundable tax credits are greater than his tax payable, if he did so, he would not receive the refundable medical expense supplement.
- Since Willa is over 17 years of age, her medical expenses are reduced by 3 percent of her Net Income For Tax Purposes.
- Due to his nil Tax Payable, George's charitable donation credit and his tuition credit are both carried forward.
- George does not qualify for the Climate Action Incentive (CAI) as a resident of Alberta. This is a refundable credit available to residents of Ontario, Saskatchewan, Manitoba and New Brunswick and is based on family size.

#### *Item Specific Notes*

- (Item 3) For couples, the CRA's administrative practices permit either spouse to claim some or all of the donations made by the couple. This is not relevant in this version as the donations are carried forward.
- (Item 5) Both ITA 118.2 and Income Tax Folio S1-F1-C1 clearly state that medical expenses can only be deducted by the individual who paid for them. However, in the T1 Guide, this rule is contradicted for couples. According to this Guide, either spouse can claim the medical expense credit, without regard to who actually paid for the expenses. This administrative position is used in practice. As a result, George is claiming the amount Deborah paid for the computer peripherals.
- (Item 6) George's receipts for the expenses eligible for the Home Accessibility Credit total more than the $10,000 maximum for the year on Schedule 12. As a result the maximum credit of $1,500 [(15%)($10,000)] is available. However, since George's non-refundable tax credits already exceed his Tax Payable, he cannot take advantage of this credit and it cannot be carried forward.
- (Item 7) The Home Buyers' Tax Credit of $750 [(15%)($5,000)] is available since George had been living in a rented town house for 5 years and neither he nor Deborah had another principal residence. However, since George's non-refundable tax credits already exceed his Tax Payable, he cannot take advantage of this credit either and it cannot be carried forward.

#### *Tax Planning Points*

- Willa should file a return in order to receive the GST credit and to help her keep track of her tuition credit carry forward.
- (Item 8) George has paid installments based on the CRA's Instalment Reminders. Given the amount of his refund, they were unnecessary. George should review his estimated net tax owing periodically in the future to determine whether instalments should be paid.

### Completed Tax Returns

The complete sample tax returns are available on MyLab in two versions, a T1 ProFile return file and a .PDF file.

## Suggestions For Working With ProFile Software

### Before You Start

To get the maximum benefit from using the ProFile tax software program, we strongly advise that you do the tutorial "Getting Started" included within the program under the Training tab. The data in the sample tax returns can be used in the tutorial. Also on the Training tab is access to "Other Training Options" which include online training and many how-to videos.

### Creating A New T1 Return

To provide some guidance on how to use ProFile to create a simple new personal tax return, we suggest the following approach.

1. Start the ProFile software. Open a new file. Ensure that you have chosen the new file in the correct software (T1) and year (2018 or 2019 if the updated data is available).
2. By default, ProFile will open on the form "Info". Fill in the highlighted cells and answer all questions that are applicable. If you do not fill in the highlighted areas, ProFile will generate an audit message. At a minimum, you will need the following information:

- Taxpayer's Social Insurance Number (SIN)
- Taxpayer's first and last name
- Address, city, province, and postal code
- Telephone number
- Taxpayer's birth date

If applicable, you will also need to enter any relevant information for the spouse on the "Info" form. At a minimum, the following information will be necessary:

- Spouse's Social Insurance Number (SIN)
- Spouse's first and last name
- Address, city, province, and postal code
- Telephone number
- Spouse's birth date

3. Using the Form Explorer (F4), go to the Dependant form and enter all relevant information about any dependants. At a minimum, the following information will be necessary:

   - Dependant's Social Insurance Number (SIN) if there is one
   - Dependant's first and last name
   - Dependant's relationship to the taxpayer
   - Dependant's birth date
   - Dependant's Net Income
   - Address, city, province, and postal code

   Note that if there are child care expenses, the information will flow here from T778. If the Dependant has tuition fee amounts, the tuition fee information should be entered on the Dependant form.

4. Using the Form Explorer (F4), open the relevant information slip form. Enter all relevant information in the appropriate forms. Some common information slip forms are:

   - T3 - Statement of Trust Income
   - T4 - Statement of Remuneration Paid
   - T5 - Statement of Investment Income
   - T2202A - Tuition Slips
   - T4AOAS - Statement of Old Age Security

5. Enter any other relevant income information on the appropriate forms. These forms may include the following:

   - S3Details - Capital Gains Entry
     (this form, not Schedule 3, must be used to input details on capital dispositions)
   - T2125 - Statement of Business Or Professional Activities
   - T2125Asset - T2125 Asset Details
   - T2125CCA - T2125 CCA Details
   - T776 - Statement of Real Estate Rentals
   - T776Asset - T776 Asset Details
   - T776CCA - T776 CCA Details

6. Enter any relevant deduction information on the appropriate forms. These forms may include the following:

   - RRSP - RRSP Deduction
   - T777 - Statement of Employment Expenses (Use the jump link to T777Details in upper right hand corner of form if applicable)
   - T778 - Child Care Expense Deduction
   - Support - Support Payments
   - Auto - Motor Vehicle Expenses

- S4 - Statement of Investment Income
(much of the information for this schedule will be carried forward from the T3, T5, and other information slips, but a few items such as carrying charges are entered directly on Schedule 4)
- LossNetCap - Net Capital Losses (carry forward information)
- LossNonCap - Non-Capital Losses (carry forward information)

7. Enter any relevant tax credit information on the appropriate forms. These forms may include the following:
   - Donations - Charitable Donations
   - Medical - Medical Expenses
8. Enter any remaining relevant information in the appropriate schedule. These schedules may include the following:
   - S2 - Federal Amounts Transferred From Your Spouse or Common-Law Partner (primarily used if spouse or common-law partner is not filing a tax return)
   - T1032 - Joint Election To Split Pension Income
9. Use the function "Show Auditor" under the "Audit" list to check for warnings or potential errors.

## Tips For Using ProFile Software

- Press the F5 key or choose Spouse from the Form menu to display the return of the spouse.
- If you cannot determine where a specific slip or other information should be input, one way to search for the correct form is to open the Form Explorer (F4) and choose the "Key" mode icon in the top right corner of the menu. If you type a key word into the line above the listing of key words, the appropriate form may be found.
- Press the F4 key to view the Form Explorer. Choose the form "Summary" to see the tax data of both spouses on the same one page summary. (Second column will be blank for a single taxpayer.)
- If you want to print only the form you have on the screen, use the print icon identified with 1 in the tool bar. The other print icon opens the print selection screen for printing complete returns. If you want to print just one copy of the return, deselect the print sets you don't want on the print selection screen. Before you print the return, review the forms that have been selected in the print set to ensure that you will not be printing forms you do not require. If it is a coupled return, the print settings for the spouse should be reviewed before clicking on Print as both returns will be printed.
- Review marks can be used to flag information that should be reviewed. The cell with the review mark will be listed when the Show Auditor feature is turned on.
- A memo and/or a tape can be attached to a cell to provide backup information.
- If you are having problems with a specific issue, go to the Training tab, "Other Training Options", to access the online how-to videos which may help solve your problems.

## Tax Software Self Study Problem - Chapter 4

**Note** The following problem contains 2018 (not 2019) information as software for 2019 is not yet available. If you have an updated 2019 version of ProFile installed on your computer, ensure that when you begin, you open a file for 2018, not 2019 as this data is for 2018. Shortly after the first filing version of the 2019 Intuit ProFile software

is available in January, 2020, the updated 2019 version of this problem will be available on MyLab at:

**http://www.pearsonmylabandmastering.com**

This Tax Software Self Study Problem is expanded in Chapter 11 to contain other components of Taxable Income and Tax Payable.

**DISCLAIMER:** All characters appearing in this problem are fictitious. Any resemblance to real persons, living or dead, is purely coincidental.

Ms. Eleanor Victoria's husband died two years ago. After her husband died, she moved from her house in Prince George, B.C., to a rented house in Victoria, B.C.

Ms. Victoria's widowed mother, Marjorie Vancouver lives with Ms. Victoria and takes care of the house, Ms. Victoria's younger daughter, Amy, and all of the household cooking. In addition to OAS benefits, Marjorie has a very small income from her deceased husband's life insurance policy. She has never filed a tax return and she is not infirm.

Diane Victoria, Eleanor's older daughter, is studying psychology at McGill University in Montreal. Her field is addiction research with a special emphasis on gambling. She does volunteer work at a gambling addiction treatment centre in Montreal in the summers. As Eleanor has paid for her tuition and living costs, Diane has agreed that the maximum tuition amount should be transferred to her mother.

Diane has decided not to file a tax return this year as she knows she does not owe any taxes. Her income was earned driving for a client of the addiction treatment centre who had lost his licence after being charged with impaired driving.

Information concerning Ms. Victoria for 2018 is given on the following pages.

**Required**: With the objective of minimizing Ms. Victoria's Tax Payable, prepare the 2018 income tax return of Eleanor Victoria using the ProFile tax software program. List any assumptions you have made, and any notes and tax planning issues you feel should be discussed with Ms. Victoria. Ignore HST implications in your solution by assuming that Ms. Victoria does not qualify for the GST/HST rebate.

| Personal Information | |
|---|---|
| Title | Ms. |
| First Name | Eleanor |
| Last Name | Victoria |
| SIN | 527-000-087 |
| Date of birth (Y/M/D) | 1971-05-15 |
| Marital Status | Widowed |
| Canadian citizen? | Yes |
| Provide information to Elections Canada? | Yes |
| Own foreign property of more than $100,000 Canadian? | No |

| Taxpayer's Address |
|---|
| 111 VVV Street Victoria, B.C. V4H 3W4 |
| Phone number (250) 111-1111 |

| Dependants | Child 1 | Child 2 | Mother |
|---|---|---|---|
| First Name | Diane | Amy | Marjorie |
| Last Name | Victoria | Victoria | Vancouver |
| SIN | 527-000-293 | None | 527-000-483 |
| Date of birth (Y/M/D) | 1998-05-14 | 2006-10-11 | 1946-05-21 |
| Net income | $2,300 | Nil | $8,000 |

| T4 | Box | Amount |
|---|---|---|
| Issuer - 1750 Canada Inc. | | |
| Employment income | 14 | 60,201.80 |
| Employee's CPP contributions | 16 | 2,593.80 |
| Employee's EI premiums | 18 | 858.22 |
| RPP contributions | 20 | 2,406.16 |
| Pension adjustment | 52 | 7,829.00 |
| Income tax deducted | 22 | 6,408.00 |
| Employment commissions | 42 | 0 |
| Union dues | 44 | 748.59 |
| Charitable donations | 46 | 175.00 |

Eleanor has a signed T2200 from her employer specifying her work requires her to have an office in the home. She meets the conditions required to deduct work space in the home expenses. Of the 1,800 square feet in the house, her office, waiting area and storage space totals 310 square feet. She doesn't qualify for the GST rebate.

During 2018 she paid the following:

| | |
|---|---|
| Rent for the year (No GST charged) | $30,000 |
| Utilities (hydro and gas) for the year | 2,500 |
| Cleaning services (No GST charged) | 1,200 |
| Insurance for household effects (No GST charged) | 400 |
| Car insurance (No GST charged) | 700 |

Eleanor and her family had the following medical expenses, all of which Eleanor paid for:

| Patient | (Y/M/D) | Medical Expenses | Description | Am't |
|---|---|---|---|---|
| Eleanor | 2018-08-15 | Grace Hospital | Ambulance charge | 392 |
| Eleanor | 2018-08-18 | Paramed Home Health | Nursing care | 1,350 |
| Marjorie | 2018-05-20 | Dr. Zhang (Optometrist) | Contact lenses | 110 |
| Marjorie | 2018-07-06 | Pharmacy | Prescription | 75 |
| Diane | 2018-09-01 | Dr. Glassman | Physiotherapist | 100 |
| Amy | 2018-05-11 | Walk Right Foot Clinic | Orthotics | 450 |
| Amy | 2018-01-23 | Dr. Tamo | Dental Fees | 1,120 |

| T2202A - (Diane) | Box | Amount |
|---|---|---|
| Tuition fees - for Diane Victoria (daughter) | A | 7,000 |
| Number of months in school - part-time | B | 2 |
| Number of months in school - full-time | C | 8 |

| Donor | Charitable Donation Receipts | Am't |
|---|---|---|
| Eleanor | Heart and Stroke | 375 |
| Eleanor | Terry Fox Foundation | 50 |
| Diane | Addiction Research Council of Canada | 100 |

## Solutions to Chapter Four Exercises

### *Exercise Four - 1 Solution*

The required Tax Payable would be calculated as follows:

| | |
|---|---|
| Tax Payable On First $47,630 At 20.05 Percent (15% + 5.05%) | $ 9,550 |
| Tax Payable On Next $9,070 ($56,700 - $47,630) At 29.65 Percent (20.5% + 9.15%) | 2,689 |
| Total Tax Payable Before Credits | $12,239 |

Her average rate of tax is 21.6 percent ($12,239 ÷ $56,700).

### *Exercise Four - 2 Solution*

Assuming Johan's wife does not have a mental or physical infirmity, the required amount would be calculated as follows:

| | |
|---|---|
| Basic Personal Amount (Johan) | $12,069 |
| Spousal Amount ($12,069 - $2,600) | 9,469 |
| Credit Base | $21,538 |
| Rate | 15% |
| Personal Tax Credits - No Infirmity | $ 3,231 |

If there was a mental or physical infirmity, the amount would be calculated as follows:

| | |
|---|---|
| Basic Personal Amount (Johan) | $12,069 |
| Spousal Amount ($12,069 + $2,230 - $2,600) | 11,699 |
| Credit Base | $23,768 |
| Rate | 15% |
| Personal Tax Credits - With Infirmity | $ 3,565 |

### *Exercise Four - 3 Solution*

As her father is not infirm, Joan would not be entitled to a Canada caregiver credit for him. She is entitled to a Canada caregiver credit for her mother who is infirm. The credit would be:

[15%][$7,140 - ($21,400 - $16,766)] = $376

### *Exercise Four - 4 Solution*

Marcia will be entitled to the spousal tax credit, including the additional amount for an infirm spouse. In addition, she can claim the Canada caregiver credit for her infirm adult son. The total credits would be calculated as follows:

| | |
|---|---|
| Spousal Including Infirm Amount ($12,069 + $2,230 - $5,600) | $ 8,699 |
| Canada Caregiver ($7,140 - Nil) | 7,140 |
| Total Base | $15,839 |
| Rate | 15% |
| Marcia's Tax Credits Related To Spouse And Son | $ 2,376 |

### *Exercise Four - 5 Solution*

Darcy would claim the Canada caregiver amount for a child under ITA 118(1)(b.1). He would also claim the eligible dependant credit for Janice. Because he claims the Canada caregiver amount for a child, he cannot claim the additional amount for an infirm eligible dependant. His total credits would be as follows:

[(15%)($2,230) + (15%)($12,069 + Nil)] = $2,145

### *Exercise Four - 6 Solution*

The base for Sandy's eligible dependant credit for her mother would be nil ($12,069 + $2,230 - $18,000), resulting in an eligible dependant tax credit of nil. Her calculation of the Canada caregiver amount would result in a base of $5,906 [$7,140 - ($18,000 - $16,766)]. As the eligible dependant tax credit was nil, the additional amount is $5,906 ($5,906 - Nil), resulting in a credit of $886 [(15%)($5,906)].

### *Exercise Four - 7 Solution*

Mr. Smythe's age credit would be $816 {[15%][$7,494 - (15%)($51,500 - $37,790)]}.

### *Exercise Four - 8 Solution*

The adoption expenses tax credit would be calculated as follows:

| | |
|---|---|
| Cost Of First China Trip | $ 4,250 |
| Cost Of Second China Trip | 6,420 |
| Chinese Orphanage Fee | 1,600 |
| Canadian Adoption Agency Fee | 3,200 |
| Legal Fees | 2,700 |
| Medical Costs (Qualify For Medical Expense Credit) | Nil |
| Total Eligible Expenses | $18,170 |

Since the $5,000 employer reimbursement is a taxable benefit and included in employment income, it does not reduce the total eligible adoption expenses.

The adoption period begins at the time that an application is made for registration with an adoption agency licensed by a provincial government. This means that all of the expenses listed in the preceding table would be eligible expenses made during the adoption period. However, for 2019, there is an overall limit of $16,255 and the maximum credit that can be claimed is $2,438 [(15%)($16,255)].

### *Exercise Four - 9 Solution*

The snow removal contract would not be a qualifying expenditure. The base for the home accessibility tax credit would be limited to the lesser of $10,000 and the qualifying expenditures of $8,500. This will result in a credit of $1,275 [(15%)($8,500)].

Either spouse can claim the credit and it will be worth the same amount to either spouse.

Since it is non-refundable, whoever claims the credit should have at least $1,275 in federal Tax Payable. Alternatively, the $8,500 base amount can be split between the two spouses.

### Exercise Four - 10 Solution

With Net Income For Tax Purposes of $350,000, the maximum base for Mr. Hoffman's credit is $262,500 [(75%)($350,000)]. As his eligible charitable gifts are less than this, he can use the full amount as the base for his credit. Given this, the calculation of the credit is as follows:

[(15%)(A)] + [(33%)(B)] + [(29%)(C)], where

A = $200
B = The Lesser Of:
- $225,000 - $200 = $224,800
- $325,000 - $210,371 = $114,629 (Note Taxable Income is used here)

C = $ [$225,000 - ($200 + $114,629)]

The charitable donation credit would be equal to $69,807, calculated as [(15%)($200)] + [(33%)($114,629)] + [(29%)($110,171)].

### Exercise Four - 11 Solution

With Net Income For Tax Purposes of $350,000, the maximum base for Ms. Hoffman's credit is $262,500 [(75%)($350,000)]. As her donation credit carry forward is less than this, she can use the full amount as the base for her credit. Given this, the calculation of the credit is as follows:

[(15%)(A)] + [(33%)(B)] + [(29%)(C)], where

A = $200
B = The Lesser Of:
- $225,000 - $200 = $224,800
- $250,000 - $210,371 = $39,629 (Note Taxable Income is used here)

C = $185,171 [$225,000 - ($200 + $39,629)]

The charitable donation credit would be equal to $66,807, calculated as [(15%)($200)] + [(33%)($39,629)] + [(29%)($185,171)]. If she had any unused portions of her 2018 donation, it would be available until 2023.

### Exercise Four - 12 Solution

| | | |
|---|---|---|
| **Amount B** Qualifying Expenses ($4,330 + $4,600) | | $ 8,930 |
| **Amount C** - Lesser Of: | | |
| • [(3%)($150,000)] = $4,500 | | |
| • 2019 Threshold Amount = $2,352 | | ( 2,352) |
| Subtotal | | $ 6,578 |
| **Amount D** | | |
| Max's Medical Expenses | $8,425 | |
| Reduced By The Lesser Of: | | |
| • $2,352 | | |
| • [(3%)($8,250)] = $248 | ( 248) | 8,177 |
| Matt's Medical Expenses | $ 120 | |
| Reduced By The Lesser Of:$2,352 | | |
| • [(3%)($6,000)] = $180 | ( 180) | Nil* |
| Allowable Amount Of Medical Expenses | | $14,755 |
| **Amount A** The Appropriate Rate (Minimum Rate) | | 15% |
| Medical Expense Tax Credit | | $ 2,213 |

* As medical expenses can only be reduced to nil, the net result cannot be negative in this calculation.

### Exercise Four - 13 Solution

As Keith has no income, his disability credit can be transferred to John. As Keith is over 17, the disability child supplement is not available. In addition to the disability credit, John will be able to take the Canada caregiver credit, as well as a credit for Keith's medical expenses.

The total credits related to Keith would be as follows:

| | | |
|---|---|---|
| Transfer Of Keith's Disability Amount | | $ 8,416 |
| Canada Caregiver | | 7,140 |
| Keith's Medical Expenses | $16,240 | |
| Reduced By The Lesser Of: | | |
| • 2019 Threshold Amount = $2,352 | | |
| • [(3%)(Nil)] = Nil | Nil | 16,240 |
| Total Credit Base | | $31,796 |
| Rate | | 15% |
| Total Credits Related To Keith | | $ 4,769 |

### Exercise Four - 14 Solution

Ms. Bright's education related tax credits would be calculated as follows:

| | | |
|---|---|---|
| Tuition Amount: | | |
| Total (Including $1,000 Prepayment) | $3,200 | |
| Ineligible Ancillary Fees ($400 - $250) | ( 150) | $3,050 |
| Interest On Student Loan | | 325 |
| Total Credit Base | | $3,375 |
| Rate | | 15% |
| Total Available Credits | | $ 506 |

### Exercise Four - 15 Solution

The available tuition credit would be calculated as follows:

| | |
|---|---|
| Tuition Amount (Maximum Transfer = $5,000) | $23,500 |
| Rate | 15% |
| Tuition Credit (Maximum Transfer = $750) | $ 3,525 |

Note that the transfer and carry forward amounts calculated in the following alternative approaches ignore his medical expense credit.

**Income Tax Act Approach** The $750 maximum transfer of the tuition credit must be reduced by Jerry's Tax Payable, before deducting his medical expense credit, of $80 [(15%)($12,600 - $12,069)]. This will leave a maximum transfer of $670 ($750 - $80) and a carry forward credit of $2,775 ($3,525 - $80 - $670).

**Tax Return Approach** The $5,000 maximum transfer of the tuition credit must be reduced by $531 ($12,600 - $12,069)], the excess of Jerry's Taxable Income over his basic personal amount. This results in a maximum transfer of $4,469 ($5,000 - $531) and a carry forward amount of $18,500 ($23,500 - $531 - $4,469). Multiplying this by 15 percent gives the same $2,775 that we calculated under the alternative approach.

### Exercise Four - 16 Solution

His tax credits would be calculated as follows:

| | |
|---|---|
| Basic Personal Amount | $ 12,069 |
| Spousal Including Infirm Amount ($12,069 + $2,230 - Nil) | 14,299 |
| Age [$7,494 - (15%)($42,000 - $37,790)] | 6,863 |
| Pension Income* | 2,000 |
| Transfer Of Spouse's Age | 7,494 |
| Transfer Of Spouse's Disability | 8,416 |
| Transfer Of Spouse's Tuition - Lesser Of: | |
| • Actual Tuition = $2,200 | |
| • Maximum Transfer = $5,000 | 2,200 |
| Credit Base | $53,341 |
| Rate | 15% |
| Total Credits | $ 8,001 |

* A payment from a life annuity purchased with funds in an RRSP is eligible pension income.

### Exercise Four - 17 Solution

Ms. Unger's $487 credit would be calculated as follows:

| | Contributions | Credit Rate | Tax Credit |
|---|---|---|---|
| First | $400 | 3/4 | $300 |
| Next | 350 | 1/2 | 175 |
| Remaining | 35 | 1/3 | 12 |
| Maximum Credit | $785 | | $487 |

### Exercise Four - 18 Solution

The regular medical expense credit would be calculated as follows:

| | |
|---|---|
| Medical Expenses | $6,250 |
| Lesser Of: | |
| • [(3%)($28,400)] = $852 | |
| • 2019 Threshold Amount = $2,352 | ( 852) |
| Allowable Amount Of Medical Expenses | $5,398 |
| Rate | 15% |
| Medical Expense Credit | $ 810 |

The refundable supplement would be calculated as follows:

| | |
|---|---|
| Lesser Of: | |
| • $1,248 (2019 Maximum) | |
| • [(25/15)($810)] = $1,350 | $1,248 |
| Reduction [(5%)($28,400 - $27,639)] | ( 38) |
| Refundable Medical Expense Supplement | $1,210 |

Ms. Brunt's total Tax Payable (Refund) would be calculated as follows:

| | | |
|---|---|---|
| Tax Payable Before Credits [(15%)($28,400)] | | $4,260 |
| Non-Refundable Credits: | | |
| Basic | $12,069 | |
| Common-Law Partner | 12,069 | |
| Allowable Medical Expenses | 5,398 | |
| Total | $29,536 | |
| Rate | 15% | ( 4,430) |
| Tax Before Refundable Supplement | | $ Nil* |
| Refundable Medical Expense Supplement | | ( 1,210) |
| Tax Payable (Refund) | | ($1,210) |

* As Tax Before Refundable Supplement can only be reduced to nil, the net result cannot be negative for this subtotal.

### *Exercise Four - 19 Solution*

Ms. Jacobi's income before deducting either the EI or OAS repayments would be as follows:

| | |
|---|---|
| Net Employment Income | $65,000 |
| EI Benefits | 10,000 |
| OAS Benefits | 7,400 |
| Income Before Deductions | $82,400 |

Dealing first with the EI repayment, Ms. Jacobi would have to repay $3,000, the lesser of:

- $3,000 [(30%)($10,000)]
- $4,808 [(30%)($82,400 - $66,375)]

Using this deduction, the clawback of her OAS payments would be the lesser of:

- $7,400, the OAS payments included in income, and
- $273 [(15%)($82,400 - $3,000 - $77,580)].

As a result, her Net Income For Tax Purposes would be as follows:

| | |
|---|---|
| Income Before Deductions | $82,400 |
| ITA 60(v.1) Deduction (EI) | ( 3,000) |
| ITA 60(w) Deduction (OAS) | ( 273) |
| Net Income For Tax Purposes | $79,127 |

## Self Study Solution Four - 1

### *Case One*

In this Case One, the combined Tax Payable would be calculated as follows:

| | | |
|---|---|---|
| Barbra's Tax Payable | | |
| Federal Tax Before Credits [(15%)($42,000)] | $ 6,300 | |
| Basic Personal Credit [($12,069)(15%)] | ( 1,810) | $ 4,490 |
| Sally's Tax Payable | | |
| Tax On First $147,667 | $30,535 | |
| Tax On Next $32,333 ($180,000 - $147,667) At 29% | 9,377 | |
| Federal Tax Before Credits | $39,912 | |
| Basic Personal Credit [($12,069)(15%)] | ( 1,810) | 38,102 |
| Combined Tax Payable | | $42,592 |

***Case Two***

In this Case Two, the Tax Payable for each individual would be the same and the combined Tax Payable would be calculated as follows:

| | | |
|---|---|---|
| Barbra's Tax Payable | | |
| Tax On First $95,259 | $16,908 | |
| Tax On Next $15,741 ($111,000 - $95,259) At 26% | 4,093 | |
| Federal Tax Before Credits | $21,001 | |
| Basic Personal Credit [($12,069)(15%)] | ( 1,810) | $19,191 |
| Sally's Tax Payable | | |
| Tax On First $95,259 | $16,908 | |
| Tax On Next $15,741 ($111,000 - $95,259) At 26% | 4,093 | |
| Federal Tax Before Credits | $21,001 | |
| Basic Personal Credit [($12,069)(15%)] | ( 1,810) | 19,191 |
| Combined Tax Payable | | $38,382 |

***Case Three***

In this Case Three, only Barbra would have Tax Payable which would be calculated as follows:

| | |
|---|---|
| Tax On First $210,371 | $48,719 |
| Tax On Next $11,629 ($222,000 - $210,371) At 33% | 3,838 |
| Federal Tax Before Credits | $52,557 |
| Basic Personal Credit [($12,069)(15%)] | ( 1,810) |
| Common-Law Partner Credit [($12,069)(15%)] | ( 1,810) |
| Barbra's Tax Payable | $48,937 |

## Self Study Solution Four - 2

***Case 1***

Leonard Wilkins will qualify for the following credits:

| | |
|---|---|
| Basic Personal Amount | $12,069 |
| Spousal ($12,069 - $8,720) | 3,349 |
| Canada Caregiver | 7,140 |
| Total Credit Base | $22,558 |
| Rate | 15% |
| Total Credits | $ 3,384 |

***Case 2***

Pete Webb will qualify for the following credits:

| | |
|---|---|
| Basic Personal Amount | $12,069 |
| Spousal ($12,069 - $3,920) | 8,149 |
| EI (Maximum) | 860 |
| CPP (Maximum) | 2,749 |
| Canada Employment | 1,222 |
| Total Credit Base | $25,049 |
| Rate | 15% |
| Total Credits | $ 3,757 |

***Case 3***

Candace Hall will qualify for the following tax credits:

| | |
|---|---|
| Basic Personal Amount | $12,069 |
| Spousal ($12,069 - $5,130) | 6,939 |
| Age [$7,494 - (15%)($69,420 - $37,790)] | 2,749 |
| Pension Income | 2,000 |
| Total Credit Base | $23,757 |
| Rate | 15% |
| Total Credits | $ 3,564 |

Note that, because her income is below the $77,580 income threshold, there will be no clawback of Ms. Hall's OAS receipts.

***Case 4***

Gladys Crawford will qualify for the following tax credits:

| | |
|---|---|
| Basic Personal Amount | $12,069 |
| Spousal ($12,069 - $2,600) | 9,469 |
| Medical Expenses (See Note) | 20,864 |
| Total Credit Base | $42,402 |
| Rate | 15% |
| Total Credits | $ 6,360 |

**Note** The claim for medical expenses is determined as follows:

| | | |
|---|---|---|
| Expenses For Gladys, Her Spouse, And Under 18 Children ($5,150 + $4,240 + $2,040 + $3,220) | | $14,650 |
| Reduced By The Lesser Of: | | |
| • [(3%)($126,470)] = $3,794 | | |
| • 2019 Threshold Amount = $2,352 | | ( 2,352) |
| 20 Year Old's Medical Expenses | $8,840 | |
| Reduced By The Lesser Of: | | |
| • [(3%)($9,130)] = $274 | | |
| • $2,352 | ( 274) | 8,566 |
| Allowable Medical Expenses | | $20,864 |

***Case 5***

Austin Schneider will qualify for the following credits:

| | |
|---|---|
| Basic Personal Amount | $12,069 |
| Eligible Dependant (See Note) | 12,069 |
| Total Credit Base | $24,138 |
| Rate | 15% |
| Total Credits | $ 3,621 |

**Note** The eligible dependant credit can be taken for any child. It should not be claimed for the 14 year old as the amount of the credit would be reduced due to his income.

## Self Study Solution Four - 3

### Federal Tax Before Credits

For all of the following Cases, the Federal Tax Before Credits would be calculated as follows:

| | |
|---|---|
| Tax On First $47,630 | $ 7,145 |
| Tax On Next $30,370 ($78,000 - $47,630) At 20.5 Percent | 6,226 |
| Federal Tax Before Credits | $13,371 |

### Case A

The solution to this Case can be completed as follows:

| | | |
|---|---|---|
| Federal Tax Before Credits (As Previously Calculated) | | $13,371 |
| Basic Personal Amount | ($12,069) | |
| Eligible Dependant | ( 12,069) | |
| Tuition | ( 5,640) | |
| Credit Base | ($29,778) | |
| Rate | 15% | ( 4,467) |
| Federal Tax Payable | | $ 8,904 |

### Case B

The solution to this Case can be completed as follows:

| | | |
|---|---|---|
| Federal Tax Before Credits (As Previously Calculated) | | $13,371 |
| Basic Personal Amount | ($12,069) | |
| EI | ( 860) | |
| CPP | ( 2,749) | |
| Canada Employment | ( 1,222) | |
| Credit Base | ($16,900) | |
| Rate | 15% | ( 2,535) |
| Charitable Donations (See Note) [(15%)($200) + (29%)($35,000 - $200)] | | ( 10,122) |
| Federal Tax Payable | | $ 714 |

**Note** With a Net Income For Tax Purposes of $78,000, Ms. Sykes' maximum claim for charitable donations is $58,500 [(75%)($78,000)]. However, if this amount was claimed, the resulting credit would exceed her Tax Payable. By claiming $35,000, the unused donation of $115,000 ($150,000 - $35,000) can be carried forward for up to 5 years. As none of her income is taxed at 33 percent, this rate will not be applicable to the calculation of the charitable donations tax credit.

The $2,000,000 that she won in the lottery is not included in her Net Income For Tax Purposes.

**Case C**

The solution to this Case can be completed as follows:

| | | |
|---|---|---|
| Federal Tax Before Credits (As Previously Calculated) | | $13,371 |
| Basic Personal Amount | ($12,069) | |
| Spousal ($12,069 - $7,600) | ( 4,469) | |
| Caregiver Amount For A Child - Martin | ( 2,230) | |
| Transfer Of Martin's Disability | ( 8,416) | |
| Disability Supplement (No Child Care Costs) | ( 4,909) | |
| Credit Base | ($32,093) | |
| Rate | 15% | ( 4,814) |
| Federal Tax Payable | | $ 8,557 |

As Harry is not mentally or physically infirm, no Canada caregiver amount is available for him.

**Case D**

The solution to this Case can be completed as follows:

| | | |
|---|---|---|
| Federal Tax Before Credits (As Previously Calculated) | | $13,371 |
| Basic Personal Amount | ($12,069) | |
| Spousal ($12,069 - $2,540) | ( 9,529) | |
| EI | ( 860) | |
| CPP | ( 2,749) | |
| Canada Employment | ( 1,222) | |
| Medical Expenses (See Note) | ( 8,199) | |
| Credit Base | ($34,628) | |
| Rate | 15% | ( 5,194) |
| Federal Tax Payable | | $ 8,177 |

**Note** The claim for medical expenses is determined as follows:

| | | |
|---|---|---|
| Wanda, Buff, And Janice ($2,100 + $360 + $3,645) | | $6,105 |
| Reduced By The Lesser Of: | | |
| • [(3%)($78,000)] = $2,340 | | |
| • 2019 Threshold Amount = $2,352 | | ( 2,352) |
| Mark's Medical Expenses | $4,520 | |
| Reduced By The Lesser Of: | | |
| • [(3%)($2,460)] = $74 | | |
| • $2,352 | ( 74) | 4,446 |
| Total Medical Expense Claim | | $8,199 |

**Case E**

The solution to this Case can be completed as follows:

| | | |
|---|---|---|
| Federal Tax Before Credits (As Previously Calculated) | | $13,371 |
| Basic Personal Amount | ($12,069) | |
| Spousal Including Infirm Amount | | |
| ($12,069 + $2,230 - $9,600) | ( 4,699) | |
| Additional Caregiver Amount (Note 1) | ( 2,441) | |
| EI | ( 860) | |
| CPP | ( 2,749) | |
| Canada Employment | ( 1,222) | |
| Transfer Of Buff's Disability Amount | ( 8,416) | |
| Transfer Of Buff's Age Amount | ( 7,494) | |
| Transfer Of Buff's Pension Amount | ( 2,000) | |
| Transfer Of Tuition Amounts (See Note 2) | ( 5,000) | |
| Credit Base | ($46,950) | |
| Rate | 15% | ( 7,043) |
| Federal Tax Payable | | $ 6,328 |

**Note 1** As the income adjusted spousal amount is less than the regular caregiver amount, there is an additional amount of $2,441 ($7,140 - $4,699).

**Note 2** While the base for Buff's tuition credit is $8,450, the transfer is limited to $5,000. The unused amount of $3,450 ($8,450 - $5,000) can be carried forward indefinitely, but can only be claimed by Buff.

## Self Study Solution Four - 4

Mr. Lane's federal tax payable (refund) would be calculated as follows:

| | | |
|---|---|---|
| Net Income For Tax Purposes And Taxable Income | | $70,000 |
| Tax On First $47,630 | | $ 7,145 |
| Tax On Next $22,370 ($70,000 - $47,630) At 20.5 Percent | | 4,586 |
| Federal Tax Before Credits | | $11,731 |
| Basic Personal Amount | ($12,069) | |
| Eligible Dependant (Note 1) | ( 12,069) | |
| EI | ( 860) | |
| CPP (maximum) | ( 2,749 | |
| Canada Employment | ( 1,222) | |
| Medical Expenses (Note 2) | ( 2,300) | |
| Credit Base | ($31,269) | |
| Rate | 15% | ( 4,690) |
| Federal Political Tax Credit [(3/4)($400) + (1/2)($50)] | | ( 325) |
| Federal Tax Payable | | 6,716 |
| CPP Overpayment ($2,784 - $2,749) | | ( 35) |
| Federal Tax Withheld (Given) | | ( 10,100) |
| Federal Tax Payable (Refund) | | ($ 3,419) |

**Note 1** The eligible dependant amount can be claimed for either his 10 or 12 year old child. His 15 year old son would not be selected as he has Net Income For Tax Purposes of $8,200.

**Note 2** Allowable medical expenses are as follows:

| | |
|---|---|
| Minor Child's Medical Expenses | $4,400 |
| Reduced By The Lesser Of: | |
| • [(3%)($70,000)] = $2,100 | |
| • 2019 Threshold Amount = $2,352 | ( 2,100) |
| Allowable Medical Expenses | $2,300 |

Since his 15 year old son is under 18 years of age, his allowable medical expenses are not affected by his Net Income For Tax Purposes. If he was 18 or older, they would be.

## Self Study Solution Four - 5

### *Part A*

The Tax Payable calculation for Marg is as follows:

| | |
|---|---|
| Taxable Income | $15,300 |
| Basic Personal Amount | ( 12,069) |
| EI | ( 248) |
| CPP | ( 602) |
| Canada Employment | ( 1,222) |
| Subtotal | $ 1,159 |
| Tuition Amount Claimed (Note 1) | ( 1,159) |
| Subtotal | Nil |
| Rate | 15% |
| Federal Tax Payable (Refund) | Nil |

**Note 1** Marg has a tuition amount available of $6,300. Of this total, she will use $1,159 to reduce her current Tax Payable to nil. This leaves an unused amount of $5,141 ($6,300 - $1,159). Of this amount, $3,841 ($5,000 - $1,159) can be transferred to her father. This will leave her with a carry forward amount of $1,300 ($6,300 - $1,159 - $3,841).

Since Marg's medical expenses were paid for by her father, she cannot claim them herself and they must be claimed by her father. Even if she had paid for them herself and claimed them, she would not increase the transfer to her father as the medical expense tax credit is not taken into consideration in determining the tuition amount that can be transferred.

### *Part B*

Mr. Barth's minimum Net Income For Tax Purposes for the year would be calculated as follows:

| | |
|---|---|
| Gross Salary | $ 82,500 |
| Additions: | |
| Bonus (Note 2) | 20,000 |
| Automobile Benefit (Note 3) | 7,580 |
| Counseling Benefit (Note 4) | 1,500 |
| Imputed Interest Benefit (Note 5) | 375 |
| Stock Option Benefit [($18 - $15)(1,000)] (Note 6) | 3,000 |
| Deductions: | |
| Registered Pension Plan Contributions | ( 3,200) |
| Professional Dues | ( 1,800) |
| Net Income For Tax Purposes | $109,955 |

**Note 2** As the bonus is not payable until more than 3 years after the end of the employer's taxation year, it is a salary deferral arrangement and must be included in income under ITA 6(11).

**Note 3** Since Mr. Barth's employment related usage is not more than 50 percent, there is no reduction of the full standby charge and he cannot use the alternative calculation of the operating cost benefit. Given this, the automobile benefit is calculated as follows:

| | |
|---|---|
| Standby Charge [(2%)($47,500)(10)] | $9,500 |
| Operating Cost Benefit [(6,000)($0.28)] | 1,680 |
| Payments Withheld | ( 3,600) |
| Taxable Benefit | $7,580 |

**Note 4** Counseling services, with the exception of those items specified under ITA 6(1), are considered taxable benefits. The items specified under ITA 6(1)(a)(iv) are counseling with respect to mental or physical health or with respect to re-employment or retirement. As a consequence, the counseling on personal finances is a taxable benefit.

**Note 5** The imputed interest benefit is calculated as follows:

| | |
|---|---|
| Taxable Benefit [($150,000)(2%)(3/12)] | $750 |
| Reduction For Interest Paid | ( 375) |
| Net Addition To Employment Income | $375 |

**Note 6** As the option price was greater than the market price at the time the options were issued, one-half of this amount can be deducted in the determination of Taxable Income. The adjusted cost base of the stock option shares is equal to their fair market value at the exercise date ($18 per share). Since they were sold for $18 per share, there is no capital gain or loss.

### *Taxable Income*

Mr. Barth's Taxable Income would be calculated as follows:

| | |
|---|---|
| Net Income For Tax Purposes = Net Employment Income | $109,955 |
| Stock Option Deduction [(1/2)($3,000)] (Note 6) | ( 1,500) |
| Taxable Income | $108,455 |

### *Tax Payable*

Mr. Barth's Tax Payable would be calculated as follows:

| | | |
|---|---|---|
| Tax On First $95,259 | | $16,908 |
| Tax On Next $13,196 ($108,455 - $95,259) At 26 Percent | | 3,431 |
| Federal Tax Before Credits | | $20,339 |
| Basic Personal Amount | ($12,069) | |
| Spousal Including Infirm Amount | | |
| ($12,069 + $2,230 - $1,250) | ( 13,049) | |
| Spouse's Disability | ( 8,416) | |
| EI | ( 860) | |
| CPP | ( 2,749) | |
| Canada Employment | ( 1,222) | |
| Medical Expenses (Note 7) | ( 1,659) | |
| Marg's Tuition Transfer (See Part A) | ( 3,841) | |
| Credit Base | ($43,865) | |
| Rate | 15% | ( 6,580) |
| Charitable Donations (Note 8) | | |
| [(15%)($200) + (29%)($2,000 - $200)] | | ( 552) |
| Net Federal Tax | | $13,207 |
| Federal Income Tax Withheld During Year | | ( 16,000) |
| Federal Tax Payable (Refund) | | ($ 2,793) |

**Note 7** Allowable medical expenses are as follows:

| | | |
|---|---|---|
| John And Spouse Medical Expenses ($200 + $3,550) | | $3,750 |
| Reduced By The Lesser Of: | | |
| • [(3%)($109,955)] = $3,299 | | |
| • 2019 Threshold Amount = $2,352 | | ( 2,352) |
| Marg's Medical Expenses | $720 | |
| Reduced By The Lesser Of: | | |
| • [(3%)($15,300)] = $459 | | |
| • $2,352 | ( 459) | 261 |
| Allowable Medical Expenses | | $1,659 |

**Note 8** As none of his income is taxed at 33 percent, this rate will not be applicable to the calculation of the charitable donations tax credit.

## Self Study Solution Four - 6

Mr. Kern's minimum Net Income For Tax Purposes for the year would be calculated as follows:

| | |
|---|---|
| Gross Salary | $67,600 |
| Additions: | |
| Automobile Benefit (Note 1) | 857 |
| Disability Insurance Benefit (Note 2) | 1,300 |
| Stock Option Benefit [($83 - $75)(200)] | 1,600 |
| Deductions: | |
| Registered Pension Plan Contributions | ( 1,800) |
| Contributions To Group Disability Plan | Nil |
| Professional Dues | ( 1,233) |
| Net Income For Tax Purposes | $68,324 |

**Note 1** Based on the fact that Mr. Kern's employment related usage is more than 50 percent of total usage, the automobile benefit is calculated as follows:

| | |
|---|---|
| Standby Charge [(2/3)(9)($815 - $89)(3,000/15,003*)] | $ 871 |
| Operating Cost Benefit - Lesser Of: | |
| • [(3,000)($0.28)] = $840 | |
| • [(1/2)($871)] = $436 | 436 |
| Total Before Payments | $1,307 |
| Payments For Personal Use [($50)(9)] | ( 450) |
| Taxable Benefit | $ 857 |

*[(9)(1,667)]

As Mr. Kern's employment related usage is more than 50 percent, he can elect to use one-half the standby charge as the operating cost benefit.

**Note 2** As his employer contributed to the plan and the contributions did not create a taxable benefit, the $1,650 in benefits received during the year must be included in employment income. However, this benefit is reduced by the $350 ($200 + $150) in total contributions that he has made in 2018 and 2019.

### Taxable Income

Taxable Income would be calculated as follows:

| | |
|---|---|
| Net Income For Tax Purposes | $68,324 |
| Stock Option Deduction [(1/2)($1,600)] | ( 800) |
| Taxable Income | $67,524 |

### Tax Payable

Tax Payable would be calculated as follows:

| | | |
|---|---|---|
| Tax On First $47,630 | | $ 7,145 |
| Tax On Next $19,894 ($67,524 - $47,630) At 20.5 Percent | | 4,078 |
| Federal Tax Before Credits | | $11,223 |
| Basic Personal Amount | ($12,069) | |
| Spousal ($12,069 - $3,660) | ( 8,409) | |
| EI | ( 860) | |
| CPP | ( 2,749) | |
| Canada Employment | ( 1,222) | |
| Medical Expenses (Note 3) | ( 3,907) | |
| David's Transfer Of Tuition (Note 4) | ( 5,000) | |
| Credit Base | ($34,216) | |
| Rate | 15% | ( 5,132) |
| Charitable Donations Carried Forward (Note 5) [(15%)($200) + (29%)($500 - $200)] | | ( 117) |
| Net Federal Tax | | $ 5,974 |
| Federal Amounts Withheld During Year (Given) | | ( 7,200) |
| Federal Tax Payable (Refund) | | ($ 1,226) |

**Note 3** The allowable medical expenses would be calculated as follows:

| | | |
|---|---|---|
| Samuel And Spouse Medical Expenses ($2,100 + $770) | | $2,870 |
| Reduced By The Lesser Of: | | |
| • [(3%)($68,324)] = $2,050 | | |
| • 2019 Threshold Amount = $2,352 | | ( 2,050) |
| David's Medical Expenses | $3,260 | |
| Reduced By The Lesser Of: | | |
| • $2,352 | | |
| • [(3%)($5,780)] = $173 | ( 173) | 3,087 |
| Allowable Medical Expenses | | $3,907 |

**Note 4** The transfer from David is as follows:

| | |
|---|---|
| Tuition Fees | $ 6,700 |
| Maximum Transfer | ( 5,000) |
| Carry Forward (For David's Use Only) | $ 1,700 |

David's Tax Payable is completely eliminated by his basic personal credit. He can transfer a maximum of $5,000 of his tuition amount to his father. The remaining $1,700 can be carried forward indefinitely, but must be used by David.

**Note 5** As none of his income is taxed at 33 percent, this rate will not be applicable to the calculation of the charitable donations tax credit.

## Self Study Solution Four - 7

Mr. Strong's minimum Taxable Income would be calculated as follows:

| | |
|---|---|
| Salary | $72,000 |
| Additions: | |
| Employer's Disability Contribution (Not A Taxable Benefit) | Nil |
| Automobile Benefit (Note 1) | 8,260 |
| Tuition For Chants Course (Note 2) | 600 |
| Travel Costs (Note 3) | Nil |
| Loan Benefit (Note 4) | 1,500 |
| Deductions: | |
| RPP Contributions | ( 4,200) |
| Cost Of Tools - Maximum (Note 5) | ( 500) |
| Net Income For Tax Purposes And Taxable Income | $77,660 |

**Note 1** The automobile benefit would be calculated as follows:

| | |
|---|---|
| Standby Charge [(2/3)(10)($565 - $40)] | $3,500 |
| Operating Cost Benefit [($0.28)(17,000)] | 4,760 |
| Total Benefits | $8,260 |

As Mr. Strong's employment related use was less than 50 percent, there is no reduction in the standby charge and he cannot use the alternative calculation of the operating cost benefit.

**Note 2** Employer paid tuition is a taxable benefit unless it is for the benefit of that employer. While the spoken French course appears to be for the benefit of the employer, it would be difficult to argue that the employer would benefit from a course in 16th century liturgical chants.

**Note 3** As the travel costs were reimbursed, there is no deduction. As long as the costs were reasonable, there would be no benefit from the reimbursement.

**Note 4** The ITA 80.4(1) loan benefit would be $1,500, the lesser of:

- [($150,000)(2% - Nil)(1/4) + ($150,000)(1% - Nil)(2/4)] $1,500
- [($150,000)(2% - Nil)(3/4)] $2,250

**Note 5** Mr. Strong can deduct the cost of tradesperson's tools that cost more than $1,222. However, the overall limit for this deduction is $500 per year.

### *Tax Payable*

Mr. Strong's federal Tax Payable would be calculated as follows:

| | | |
|---|---|---|
| Tax On First $47,630 | | $ 7,145 |
| Tax On Next $30,030 ($77,660 - $47,630) At 20.5 Percent | | 6,156 |
| Tax Before Credits | | $13,301 |
| Credits: | | |
| Basic Personal Amount | ($12,069) | |
| Spousal ($12,069 - $5,600) | ( 6,469) | |
| Canada Caregiver (Note 6) | Nil | |
| EI Premiums | ( 860) | |
| CPP Contributions | ( 2,749) | |
| Canada Employment | ( 1,222) | |
| Tuition (Note 7) | ( 600) | |
| Medical Expenses (Note 8) | ( 3,775) | |
| Credit Base | ($27,744) | |
| Rate | 15% | ( 4,162) |
| Charitable Donations (Note 9) [(15%)($200) + (29%)($1,200 - $200)] | | ( 320) |
| Federal Tax Payable | | $ 8,819 |

**Note 6** Because his mother is not mentally or physically infirm, Lance cannot claim the Canada caregiver credit.

**Note 7** When an employer reimburses tuition costs, the tuition credit can be claimed if the reimbursement is included in the employee's income. (See Note 2.)

**Note 8** The base for Mr. Strong's medical expense credit can be calculated as follows:

| | | |
|---|---|---|
| Mr. Strong, His Spouse, And Minor Children ($1,250 + $2,300 + $850) | | $4,400 |
| Reduced By The Lesser Of: | | |
| • [(3%)($77,660)] = $2,330 | | |
| • 2019 Threshold Amount = $2,352 | | ( 2,330) |
| Mother's Medical Expenses | $1,960 | |
| Reduced By The Lesser Of: | | |
| • $2,352 | | |
| • [(3%)($8,500)] = $255 | ( 255) | 1,705 |
| Allowable Medical Costs | | $3,775 |

**Note 9** Mr. Strong cannot claim a credit for the $1,500 of donated services. As none of his income is taxed at 33 percent, this rate will not be applicable to the calculation of the charitable donations tax credit.

**Note 10** Mr. Strong cannot claim the First-Time Home Buyers' Credit as he owned a house within 4 years of purchasing the heritage home.

## Self Study Solution Four - 8

***Part A***

Mr. Bosworth's minimum Net Income For Tax Purposes would be calculated as follows:

| | |
|---|---|
| Salary | $180,000 |
| Additions: | |
| Commissions | 11,500 |
| Bonus (Note 1) | Nil |
| Life Insurance Premiums (Employer's Contribution) | 460 |
| Automobile Benefit (Note 2) | 6,800 |
| Stock Option Benefit (Note 3) | 13,000 |
| Gift ($2,500, Less $500 Limit On Gifts) | 2,000 |
| Deductions: | |
| RPP Contributions | ( 5,200) |
| Employment Expenses (Note 4) | ( 20,371) |
| Net Income For Tax Purposes | $188,189 |

**Note 1** As none of the bonus was paid during the year, none of it will be included in Net Income For Tax Purposes.

**Note 2** The standby charge would be calculated as follows:

$$[(2/3)(12)(\$925 - \$75)(20,004 \div 20,004)] = \$6,800$$

As Mr. Bosworth's personal milage exceeds 20,004 kilometers, there is no reduction in the standby charge. There would be no operating cost benefit as Mr. Bosworth paid for all of the operating costs.

**Note 3** The total employment income inclusion would be $13,000 [(5,000)($12.35 - $9.75)]. As the option price was equal to the market price at the time the options were issued, $6,500 [(1/2)($13,000)] can be deducted in the determination of Taxable Income.

**Note 4** Potentially deductible expenses are as follows:

| | |
|---|---|
| Car Operating Costs [(41,000 ÷ 62,000)($10,300)] | $ 6,811 |
| Meals [(50%)($6,420)] | 3,210 |
| Hotels | 10,350 |
| **Subtotal for ITA 8(1)(h) and (h.1)** | **$20,371** |
| Advertising | 12,400 |
| Entertainment [(50%)($6,500)] | 3,250 |
| **Total for ITA 8(1)(f) - Limited To Commissions** | **$36,021** |

All of these costs can be deducted under ITA 8(1)(f). However, the total deduction is limited to commission income which is only $11,500. Alternatively, the car operating costs, meals, and hotels, can be deducted under ITA 8(1)(h) and (h.1). As shown in the preceding table, this total would be $20,371. As Mr. Bosworth cannot simultaneously use ITA 8(1)(f) and the combination of ITA 8(1)(h) and (h.1), he will minimize his Net Income For Tax Purposes by deducting under the latter provisions.

***Part B***

Mr. Bosworth's minimum Taxable Income would be calculated as follows:

| | |
|---|---|
| Net Income For Tax Purposes | $188,189 |
| Stock Option Deduction [(1/2)($13,000)] | ( 6,500) |
| Taxable Income | $181,689 |

***Part C***

Based on the Taxable Income calculated in Part B, Mr. Bosworth's federal Tax Payable would be calculated as follows:

| | | |
|---|---|---|
| Tax On First $147,667 | | $30,535 |
| Tax On Next $34,022 ($181,689 - $147,667) At 29 Percent | | 9,866 |
| Tax Before Credits | | $40,401 |
| Credits: | | |
| Basic Personal Amount | ($12,069) | |
| Spouse ($12,069 - $6,450) | ( 5,619) | |
| Canada Caregiver Amount For Child | ( 2,230) | |
| Transfer Of Daughter's Disability | ( 8,416) | |
| Disability Supplement (Note 5) | Nil | |
| EI Premiums | ( 860) | |
| CPP Contributions | ( 2,749) | |
| Canada Employment | ( 1,222) | |
| Tuition - Andrew | ( 1,670) | |
| Transfer Of Son's Tuition (Note 6) | ( 4,619) | |
| Medical Expenses (Note 7) | ( 14,314) | |
| Credit Base | ($53,768) | |
| Rate | 15% | ( 8,065) |
| Charitable Donations (Note 8) | | |
| [(15%)($200) + (29%)($2,400 - $200)] | | ( 668) |
| Federal Tax Payable | | $31,668 |

**Note 5** Since the daughter's $9,000 attendant care costs that are included in the medical expenses total more than $7,784 ($4,909 + $2,875), the disability supplement is reduced to nil.

**Note 6** As the son has Net Income For Tax Purposes of $12,450, he must use $381 ($12,450 - $12,069) of this total. This means that the maximum transfer to his father will be $4,619 ($5,000 - $381). This will leave the son with the following carry forward:

| | |
|---|---|
| Tuition Amount Including Ancillary Fees ($7,650 + $560) | $8,210 |
| Used By Son In 2019 | ( 381) |
| Transferred To His Father | ( 4,619) |
| Carry Forward (For Son's Use Only) | $3,210 |

The carry forward amount $3,210 can be carried forward indefinitely, but must be used by the son.

**Note 7** The base for Mr. Bosworth's medical expense credit can be calculated as follows:

| | | |
|---|---|---|
| Eligible Medical Expenses<br>Andrew, His Spouse And Minor Child<br>($1,200 + $2,250 + $11,250) | | $14,700 |
| Reduced By The Lesser Of:<br>• [(3%)($188,189)] = $5,646<br>• 2019 Threshold Amount = $2,352 | | ( 2,352) |
| Son's Medical Expenses | $2,340 | |
| Reduced By The Lesser Of:<br>• $2,352<br>• [(3%)($12,450)] = $374 | ( 374) | 1,966 |
| Allowable Medical Expenses | | $14,314 |

**Note 8** As none of his income is taxed at 33 percent, this rate will not be applicable to the calculation of the charitable donations tax credit.

## Solution to Tax Software Self Study Problem - Chapter 4

The complete tax return is available on MyLab in two versions, a T1 ProFile return file and a .PDF file. Note that prior to late January, 2020, the returns will be for 2018, not 2019 as the 2019 filing version will not yet be available.

For more information on how to use the ProFile tax program, refer to the Chapter 4 sample tax return in this Study Guide.

### *Notes To Tax Return*

- Diane transfers the $5,000 maximum tuition amount to Eleanor and carries forward the remaining $2,000 [$7,000 - $5,000]. The carry forward can only be used by Diane.
- Eleanor cannot claim the charitable donation made by Diane, but Diane can carry it forward for up to 5 years.
- Since Amy is under 18 and wholly dependent, Eleanor claimed the eligible dependant credit for Amy.
- Because Marjorie is not infirm, Eleanor can claim no credit for her.
- Since Diane and Marjorie are over 17 years of age, their medical expenses are reduced by 3 percent of their Net Income For Tax Purposes. This means that none of Marjorie's medical expenses can be claimed by Eleanor.
- In calculating work space in the home costs, the household insurance is not deductible as the T4 information shows she has no commission income. The car insurance is not relevant as there is no information that Eleanor uses her car for employment related purposes.

### *Tax Planning Points*

- Although she is not required to file, Marjorie should file a tax return, otherwise she will not be eligible for the GST credit.
- Although she is not required to file, Diane should file a tax return, otherwise she will not be eligible for the GST credit and she will not benefit from the RRSP deduction room created during the year. Filing a tax return will also make her tuition credit and charitable donation tax credit easier to keep track of for carry forward purposes.

# Chapter 4 Learning Objectives

### *Note Regarding Rates And Credits*

A schedule of rates, brackets, credit amounts and other data is available at the beginning of both Volumes of this textbook, (but not this Study Guide) and on MyLab. We expect you to refer to this information when calculating the credits covered in this chapter (i.e., you are not expected to memorize the rates, brackets and credit bases).

After completing Chapter 4, you should be able to:

1. Calculate Taxable Income when an individual has basic deductions against Net Income For Tax Purposes. (paragraph [P hereafter] 4-1 to 4-9).
2. Calculate federal and provincial Tax Payable before the consideration of any tax credits (P 4-10 to 4-32).
3. Calculate the personal tax credits described in ITA 118(1) which include the:
    - spousal,
    - eligible dependant,
    - Canada caregiver for a child,
    - basic,
    - Canada caregiver (P 4-33 to 4-61).
4. Calculate the age tax credit (P 4-62 and 4-63).
5. Calculate the pension income tax credit (P 4-64 to 4-68).

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6. Calculate the Canada employment tax credit (P 4-69 to 4-71).
7. Calculate the adoption expenses tax credit (P 4-72 to 4-76).
8. Calculate the digital news subscriptions credit that is effective in 2020 (P 4-77 to 4-78).
9. Calculate the home accessibility tax credit (P 4-79 to 4-89).
10. Calculate the first time home buyer's tax credit (P 4-90 to 4-92).

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11. Calculate the volunteer firefighters and search and rescue workers tax credit (P 4-93 to 4-96).
12. Calculate the charitable donations tax credit when the donation is in the form of cash (P 4-97 to 4-108).
13. Calculate the medical expense tax credit (P 4-109 to 4-119).
14. Calculate the disability tax credit (P 4-120 to 4-130).
15. Calculate the tax credits related to tuition fees, examination fees, ancillary fees, and student loan interest. (P 4-131 to 4-138).

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16. Calculate the amount of education related tax credits that can be carried forward or transferred to another individual (P 4-139 to 4-148).
17. Calculate the Employment Insurance and Canada Pension Plan credits (P 4-149 to 4-155).
18. List the types and amounts of tax credits that can be transferred to a spouse or common-law partner (P 4-156 to 4-158).
19. Calculate the political contributions tax credit (P 4-159 to 4-162).
20. Calculate the labour sponsored venture capital corporation tax credit (P 4-163 to 4-167).
21. Explain the basic provisions of the refundable GST credit (P 4-168 to 4-175).

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22. Calculate the refundable medical expense supplement (P 4-176 to 4-179).
23. Calculate the Canada Workers Benefit (P 4-180 to 4-183).
24. Calculate the refundable teacher and early childhood educator school supply tax credit (P 4-184 to 4-186).
25. Explain the climate action incentive payments (refundable credit) (P 4-187 to 4-194).
26. Calculate the OAS and EI clawbacks (P 4-195 to 4-212).
27. Complete a simple personal tax return using the ProFile T1 tax preparation software program.

# CHAPTER 5

## How To Work Through Chapter 5

We recommend the following approach in dealing with the material in this chapter:

**Tax And Accounting Procedures Compared**

- Read the beginning of the chapter to 5-11 (in the textbook).

**Additions To Capital Cost, Including Available For Use Rules**

- Read paragraph 5-12 to 5-32.

**Capital Cost Allowances - General Overview and Rates For Common Classes**

- Read paragraph 5-33 to 5-36.
- Do Exercises Five-1 and Five-2 (in the textbook) and check the solutions in this Study Guide.

**Half-Year (a.k.a. First Year) Rules**

- Read paragraph 5-37 to 5-41.

**Accelerated Investment Incentive (AccII)**

- Read paragraph 5-42 to 5-54.
- Do Exercise Five-3 and check the solution in this Study Guide.

**AccII Application - Classes 12 and 13**

- Read paragraph 5-55 to 5-58.
- Do Exercise Five-4 and check the solution in this Study Guide.

**AccII Application - Class 14**

- Read paragraph 5-59.
- Do Exercise Five-5 and check the solution in this Study Guide.

**AccII Application - Class 53**

- Read paragraph 5-60.
- Do Exercise Five-6 and check the solution in this Study Guide.

**Zero Emission Vehicles**

- Read paragraph 5-61 to 5-67.

**Short Fiscal Periods**

- Read paragraph 5-68 to 5-70.
- Do Exercise Five-7 and check the solution in this Study Guide.

**Class 14.1 (Including Goodwill) And The Repeal Of The CEC Regime**

- Read paragraph 5-71 to 5-85.

**Tax Planning Considerations For CCA**

- Read paragraph 5-86 to 5-90.
- Do Exercise Five-8 and check the solution in this Study Guide.

**Dispositions Of Depreciable Assets**

- Read paragraph 5-91 to 5-99.
- Do Exercise Five-9 and check the solution in this Study Guide.

**Recapture of Capital Cost Allowance**

- Read paragraph 5-100 to 5-103.
- Do Exercise Five-10 and check the solution in this Study Guide.

**Terminal Losses**

- Read paragraph 5-104 to 5-108.
- Do Exercises Five-11 and Five-12 and check the solutions in this Study Guide.

**Dispositions of Class 54 Assets (Zero Emission Vehicles)**

- Read paragraph 5-109 to 5-111.

**Dispositions Of Class 14.1 - Differences From Other Classes**

- Read paragraph 5-112 to 5-118.
- Do Exercise Five-13 and check the solution in this Study Guide.
- Read paragraph 5-119 to 5-121.

**Summary Of Tax Consequences**

- Read paragraph 5-122.

**CCA Schedule - Example**

- Read paragraph 5-123 to 5-124.
- Do Self Study Problems Five-1 to Five-7 which are available on MyLab and check the solutions in this Study Guide.

**Separate Class Election**

- Read paragraph 5-125 to 5-132.
- Do Exercise Five-14 and check the solution in this Study Guide.
- Read paragraph 5-133 to 5-134.

**Change In Use For Automobiles And Other Special Situations**

- Read paragraph 5-135 to 5-140.

**CEC To Class 14.1 - Transitional Rules**

- Read paragraph 5-141 to 5-151.
- Do Exercise Five-15 and check the solution in this Study Guide.
- Read paragraph 5-152 to 5-156.
- Do Exercise Five-16 and check the solution in this Study Guide.
- Read paragraph 5-157 to 5-161.
- Do Exercise Five-17 and check the solution in this Study Guide.
- Read paragraph 5-162 to 5-170.
- Do Self Study Problem Five-8 and check the solution in this Study Guide.
- Read paragraph 5-171 to 5-175.

**To Complete This Chapter**

- If you would like more practice in problem solving, do the Supplementary Self Study Problems for the chapter. These problems and solutions are available on MyLab.
- Review the Key Terms Used In This Chapter in the textbook at the end of Chapter 5. Consult the Glossary for the meaning of any key terms you do not know.

- Test yourself with the Chapter 5 Glossary Flashcards available on MyLab.
- Ensure you have achieved the Chapter 5 Learning Objectives listed in this Study Guide.
- As a review, we recommend you view the PowerPoint presentation for Chapter 5 that is on MyLab.

**Practice Examination**

- Write the Practice Examination for Chapter 5 that is on MyLab. Mark your examination using the Practice Examination Solution that is also on MyLab.

## Solutions to Chapter Five Exercises

### *Exercise Five - 1 Solution*

The correct classes for each of the assets would be as follows:

| Asset | Class |
|---|---|
| Taxicab | 16 |
| Manufacturing and processing equipment | 53 |
| Franchise with a limited life | 14 |
| Passenger vehicle with a cost of $120,000* | 10.1 |
| Government licence with an unlimited life | 14.1 |
| Water storage tank | 6 |
| Photocopy machine (office equipment not specifically listed elsewhere) | 8 |
| Leasehold improvements | 13 |
| Rental building* (not including the land) | 1 |

*These two assets would have to be allocated to separate classes. In addition, as covered later in the Chapter, the taxpayer could elect to include the photocopy machine in a separate class if its capital cost is $1,000 or more.

### *Exercise Five - 2 Solution*

Ignoring the half-year rule, the impact would be calculated as follows:

| | |
|---|---|
| Correct CCA [($326,000)(30%)] | $97,800 |
| CCA Recorded In 2019 [($326,000)(4%)] | ( 13,040) |
| Understatement Of 2019 CCA | $84,760 |

### *Exercise Five - 3 Solution*

The maximum CCA for 2019 and the January 1, 2020 UCC balance are calculated as follows:

| | | |
|---|---|---|
| January 1, 2019 UCC | | $ 950,000 |
| Add: Acquisitions During The Year | $300,000 | |
| Deduct: Dispositions During The Year* | ( 144,000) | 156,000 |
| Add: AccII Adjustment [(1/2)($156,000)] | | 78,000 |
| CCA Base (December 31, 2019 UCC) | | $1,184,000 |
| 2019 CCA [(30%)($1,184,000)] | | ( 355,200) |
| AccII Adjustment Reversal | | ( 78,000) |
| January 1, 2020 UCC | | $ 750,800 |

*The detailed coverage on dispositions is later in the Chapter. We have included dispositions during the year to more fully illustrate the calculation of the AccII adjustment. More accurately, dispositions are the lesser of the capital cost and the proceeds of disposition. To simplify the AccII calculations, this Exercise does not provide the capital cost of the cars disposed of.

### Exercise Five - 4 Solution

The required CCA calculations for 2019 would be as follows:

| | |
|---|---|
| On 2014 Improvements ($52,000 ÷ 15) | $3,467 |
| On 2019 Improvements [(150%)($31,000 ÷ 10)] | 4,650 |
| 2019 CCA | $8,117 |

The required CCA calculations for 2020 would be as follows:

| | |
|---|---|
| On 2014 Improvements ($52,000 ÷ 15) | $3,467 |
| On 2019 Improvements ($31,000 ÷ 10) | 3,100 |
| 2020 CCA | $6,567 |

While this is not required by the Exercise, you should note that the 2028 CCA on the 2019 improvements would be limited to $1,550 ($31,000 - $4,650 - (8)($3,100)], the balance in the UCC for these improvements.

### Exercise Five - 5 Solution

The required calculations are as follows:

| | |
|---|---|
| Acquisition Amount | $375,000 |
| CCA For 2019 [(150%)($375,000 ÷ 10)(275/365)] | ( 42,380) |
| January 1, 2020 UCC | $332,620 |

### Exercise Five - 6 Solution

The required calculations are as follows:

| | |
|---|---|
| January 1, 2019 UCC | $500,000 |
| Acquisitions During The Year | 100,000 |
| AccII Adjustment [(100%)($100,000)] | 100,000 |
| CCA Base | $700,000 |
| 2019 CCA [(50%)($700,000)] | ( 350,000) |
| AccII Adjustment Reversal | ( 100,000) |
| January 1, 2020 UCC | $250,000 |

While this is not required, the ending UCC can be verified as follows:

| | |
|---|---|
| January 1, 2019 UCC | $500,000 |
| Acquisitions During The Year | 100,000 |
| Write-Offs: | |
| CCA On Opening UCC [(50%)($500,000)] | ( 250,000) |
| CCA On Additions [(100%)($100,000)] | ( 100,000) |
| January 1, 2020 UCC | $250,000 |

### Exercise Five - 7 Solution

The required information is calculated as follows:

| | |
|---|---|
| Capital Cost Of Additions | $115,000 |
| AccII Adjustment [(50%)($115,000)] | 57,500 |
| CCA Base | $172,500 |
| 2019 CCA [(20%)($172,500)(153/365)] | ( 14,461) |
| AccII Adjustment Reversal | ( 57,500) |
| January 1, 2020 UCC | $100,539 |

### Exercise Five - 8 Solution

Following the general rule that, when less than the maximum CCA is to be deducted, the amounts deducted should be taken from the class(es) with the lowest rates, the required calculations would be as follows:

| | | |
|---|---|---|
| Required Total | | $45,000 |
| Maximum CCA - Class 1 [(4%)($426,000)] | ($17,040) | |
| Maximum CCA - Class 8 [(20%)($126,000)] | ( 25,200) | ( 42,240) |
| Required Balance | | $ 2,760 |

As they are both 30 percent declining balance classes, the remaining $2,760 could be taken from either Class 10 or Class 10.1. It would be advisable to use Class 10.1, as recapture is not recorded for this class. In addition, if the Class 10.1 vehicle is going to be disposed of in the near future, it could be better tax planning to take the maximum CCA for Class 10.1 of $6,300 [(30%)($21,000)] and reduce the Class 8 CCA to $21,660 ($45,000 - $6,300 - $17,040). Since there is no recapture for Class 10.1, this could increase aggregate future deductions of the other classes. Whether this would be advantageous depends on the anticipated proceeds of disposition.

### Exercise Five - 9 Solution

The only tax consequence would be a taxable capital gain of $2,500 [(1/2)($23,000 - $18,000)].

Following the basic rule for dispositions, we would subtract from the Class 8 UCC the lesser of the proceeds of disposition ($23,000) and the capital cost of the individual asset ($18,000). Subtracting the lesser figure of $18,000 would leave a large positive balance in Class 8. As there are no other dispositions during the year, we can conclude that the balance will be positive at the end of the year. This fact, combined with the presence of many other assets in Class 8 means that there will be no recapture and no terminal loss.

### Exercise Five - 10 Solution

The required information would be calculated as follows:

| | |
|---|---|
| UCC Of The Class At The Beginning Of The Year | $24,883 |
| Add: Acquisitions During The Year | Nil |
| Deduct: Dispositions During The Year - Lesser Of: | |
| • Capital Cost = $27,000 | |
| • Proceeds Of Disposition = $28,500 | ( 27,000) |
| Deduct: One-Half Net Additions | N/A* |
| Negative Ending Balance | ($ 2,117) |
| Recapture Of CCA | 2,117 |
| January 1, 2020 UCC Balance | Nil |

*This adjustment for one-half of the excess of additions over disposal deductions is only made when the net amount is positive.

The effect would be an addition to business income of $2,117 in recaptured CCA. Note that, unlike terminal losses (See Exercise Five-11), the fact that there is still an asset in the class is irrelevant.

While there would also be a taxable capital gain of $750 [(1/2)($28,500 - $27,000)], this would not be included in business income.

### Exercise Five - 11 Solution

The required information would be calculated as follows:

| | |
|---|---|
| UCC Of The Class At The Beginning Of The Year | $24,883 |
| Add: Acquisitions During The Year | Nil |
| Deduct: Dispositions During The Year - Lesser Of: | |
| • Capital Cost = $54,000 | |
| • Proceeds Of Disposition = $18,000 | ( 18,000) |
| Ending Balance With No Remaining Assets | $ 6,883 |
| Terminal Loss | ( 6,883) |
| January 1, 2020 UCC Balance | Nil |

As there is a positive balance in Class 8 at the end of the year, but no remaining assets, there would be a terminal loss of $6,883. This loss is deducted in the calculation of net business income.

### *Exercise Five - 12 Solution*

The accounting results would be calculated as follows:

| | |
|---|---|
| Proceeds Of Disposition | $126,000 |
| Net Book Value | ( 43,500) |
| Accounting Gain | $ 82,500 |

For tax purposes, there would be a taxable capital gain calculated as follows:

| | |
|---|---|
| Proceeds Of Disposition | $126,000 |
| Capital Cost | ( 97,000) |
| Capital Gain | $ 29,000 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain | $ 14,500 |

The capital cost of $97,000 would be subtracted from the UCC, leaving a balance of $2,365,000 ($2,462,000 - $97,000).

While this disposition would reduce the maximum CCA for the current and subsequent years, there would be no recapture (the balance in Class 8 is still positive) or terminal loss (there are still assets in Class 8).

### *Exercise Five - 13 Solution*

CCA on Class 14.1 for 2019 would be calculated as follows:

| | |
|---|---|
| January 1, 2019 Balance | Nil |
| 2019 Additions ($85,000 + $105,000) | $190,000 |
| AccII Adjustment [(1/2)($190,000)] | 95,000 |
| CCA Base | $285,000 |
| 2019 CCA [(5%)($285,000)] | ( 14,250) |
| AccII Adjustment Reversal | ( 95,000) |
| January 1, 2020 UCC | $175,750 |
| Deduct: Dispositions During The Year - Lesser Of: | |
| Capital Cost = $190,000 (See Note) | |
| Proceeds Of Disposition = | |
| ($65,000 + $105,000) = $170,000 | ( 170,000) |
| UCC Subsequent to The Sales | $ 5,750 |

**Note** The capital cost of the single goodwill asset is $190,000 ($85,000 + $105,000).

There would be no immediate tax consequences resulting from the dispositions. Subsequent to the sales, Dextrin Inc. has a Class 14.1 UCC of $5,750 consisting of goodwill with a capital cost of $20,000 ($190,000 - $170,000).

### Exercise Five - 14 Solution

Photocopiers would be included in Class 8, a 20 percent declining balance class. The following table compares the CCA if no election is made with the results if the separate class election is made.

| | No Election 10 Copiers | With Election 2 Copiers | With Election 8 Copiers |
|---|---|---|---|
| January Acquisitions @ $20,000 | $200,000 | $40,000 | $160,000 |
| Dispositions | ( 6,000) | ( 6,000) | N/A |
| Terminal Loss | | $34,000 | |
| December Acquisitions @ $22,000 | 44,000 | $44,000 | |
| AccII Adjustments | 119,000 | 22,000 | 80,000 |
| CCA Base | $357,000 | $66,000 | $240,000 |
| CCA Rate | 20% | 20% | 20% |
| CCA | $ 71,400 | $13,200 | $ 48,000 |

If no election is made, there will be a deduction for CCA of $71,400. Alternatively, if each machine is allocated to a separate class, there will be a deduction for CCA of $61,200 ($13,200 + $48,000). In addition, there will be a terminal loss of $34,000. The use of the election increases the total deductible amount by $23,800 [($13,200 + $48,000) + $34,000 Terminal Loss - $71,400].

### Exercise Five - 15 Solution

The maximum Class 14.1 CCA for 2018 would be calculated as follows:

| | Pre-2017 CEC | Post-2016 Assets |
|---|---|---|
| Opening UCC | $149,610 | Nil |
| Maximum 2017 CCA [(7%)($149,610)] | 10,473 | Nil |
| January 1, 2018 Balance | $139,137 | Nil |
| Add: Acquisitions During The Year | N/A | $89,000 |
| Deduct: One-Half Net Additions | N/A | ( 44,500) |
| CCA Base | $139,137 | $44,500 |
| CCA Rate | 7% | 5% |
| Maximum 2018 CCA | $ 9,740 | $ 2,225 |

The total CCA for Class 14.1 is equal to $11,965 ($9,740 + $2,225).

### Exercise Five - 16 Solution

The amount that would have been added to the CEC account in 2014 totalled $150,000 [(3/4)($120,000 + $80,000)]. Using this information, the capital cost of the two unlimited life franchises would be calculated as follows:

| | |
|---|---|
| [(4/3)($120,654)] | $160,872 |
| [(4/3)($150,000 - $120,654)] | 39,128 |
| Capital Cost - Unlimited Life Franchises | $200,000 |

Note that the capital cost is equal to the amount paid since there have been no dispositions.

### *Exercise Five - 17 Solution*

The relevant calculations here are as follows:

| | |
|---|---|
| CEC Additions [(3/4)(($126,000 + $185,000 + $94,000)] | $303,750 |
| Dispositions [(3/4)($142,000 + $220,000)] | ( 271,500) |
| CEC Balance | $ 32,250 |
| 2016 CEC Deduction [(7%)($32,250)] | ( 2,258) |
| December 31, 2016 CEC | $ 29,992 |

The total capital cost for the remaining asset is calculated as follows:

| | |
|---|---|
| [(4/3)($29,992)] | $39,989 |
| [(4/3)($2,258)] | 3,011 |
| Capital Cost | $43,000 |

The excess of the proceeds of disposition over the original capital cost of the two dispositions was $51,000 [($142,000 - $126,000) + ($220,000 - $185,000)]. This leaves a capital cost of $43,000 ($94,000 - $51,000) for the remaining asset.

## Self Study Solution Five - 1

The required calculation of the maximum CCA is as follows:

| | Class 1 | Class 8 | Class 10 |
|---|---|---|---|
| Opening Balance | $2,597,000 | $718,000 | $524,000 |
| Additions | Nil | Nil | 374,000 |
| Dispositions | | | |
| Proceeds Of Disposition | Nil | Nil | ( 234,000) |
| AccII Adjustment | | | |
| [(1/2)($374,000 - $234,000)] | Nil | Nil | 70,000 |
| CCA Base | $2,597,000 | $718,000 | $734,000 |
| CCA Rate | 4% | 20% | 30% |
| Maximum CCA | $ 103,880 | $143,600 | $220,200 |

This gives a maximum amount for CCA of $467,680 for the taxation year ($103,880 + $143,600 + $220,200).

### *Part B*

Since the Company only has Net and Taxable Income before CCA of $328,000 and the problem states that loss carry overs should not be considered, maximum CCA would not be deducted as this would produce a loss. Only $328,000 in CCA should be taken in order to reduce the Taxable Income to nil.

Given that the CCA deduction is limited to $328,000, it would normally be deducted in the class or classes with the lowest rates. This would leave the unused amounts in classes with higher rates which, in turn, would maximize the amount that could be deducted in the first profitable years. Taking this approach, the $328,000 would be deducted as follows:

| | |
|---|---|
| Class 1 (Maximum Available) | $103,880 |
| Class 8 (Maximum Available) | 143,600 |
| Class 10 (Required Balance) | 80,520 |
| Total CCA | $328,000 |

This CCA deduction would reduce Taxable Income to nil.

Note that if there were immediate plans to sell the building for more than its opening UCC, this could affect the choice of Classes to deduct CCA from as any additional CCA taken on Class 1 would have to be added to income as recaptured CCA when the building is sold.

## Self Study Solution Five - 2

### *Class 1*

The required information is calculated as follows:

| | |
|---|---|
| Opening Balance | $115,000 |
| Additions | Nil |
| Dispositions - Lesser Of: | |
| • Cost = $190,000 | |
| • Proceeds Of Disposition = $110,000 | ( 110,000) |
| Ending Balance With No Remaining Assets In Class | $ 5,000 |
| Terminal Loss | ( 5,000) |
| January 1, 2020 UCC Balance | Nil |

Since the building sold is the last asset in the class, there is a terminal loss of $5,000 which is deducted in the determination of business income. The proceeds of disposition for the building total $110,000 ($260,000 - $150,000). As the adjusted cost base of the land is equal to the proceeds of disposition, there is no gain on the disposition of the land.

### *Class 8*

The required information is calculated as follows:

| | | |
|---|---|---|
| Opening Balance | | $ 96,000 |
| Additions | $52,000 | |
| Dispositions - Lesser Of: | | |
| • Cost = $75,000 | | |
| • Proceeds Of Disposition = $35,000 | ( 35,000) | 17,000 |
| AccII Adjustment [(1/2)($17,000)] | | 8,500 |
| CCA Base | | $121,500 |
| CCA At 20 Percent | | ( 24,300) |
| AccII Adjustment Reversal | | ( 8,500) |
| January 1, 2020 UCC Balance | | $ 88,700 |

### *Class 10*

The required information is calculated as follows:

| | | |
|---|---|---|
| Opening Balance | | $ 6,700 |
| Additions | $ 8,000 | |
| Dispositions - Lesser Of: | | |
| • Cost = $20,000 | | |
| • Proceeds = $25,000 | ( 20,000) | ( 12,000) |
| AccII Adjustment (Only If Net Additions Are Positive) | | N/A |
| Negative Ending Balance | | ($ 5,300) |
| Recaptured CCA (i.e. Recapture) | | 5,300 |
| January 1, 2020 UCC Balance | | Nil |

As the cost of the used car is less than $30,000, its cost is added to Class 10. With respect to the retirement, only the capital cost of the truck sold is deducted from Class 10. The excess of the $25,000 proceeds over the capital cost of $20,000 is a $5,000 capital gain, one-half of which would be taxable. The $12,000 net deduction creates a negative balance in the class and, as a consequence, no CCA will be taken for 2019. However, the negative balance of $5,300 will have to be taken into income as recapture.

### Class 53

The required information is as follows:

| | |
|---|---|
| Opening Balance | $75,000 |
| CCA At 50 Percent | ( 37,500) |
| January 1, 2020 UCC Balance | $37,500 |

### Summary Of Results (Required)

The preceding results can be summarized as follows:

| | |
|---|---|
| Terminal Loss - Class 1 | ($ 5,000) |
| CCA - Class 8 | ( 24,300) |
| Recapture - Class 10 | 5,300 |
| CCA - Class 53 | ( 37,500) |
| Decrease In Net Business Income | ($61,500) |
| Taxable Capital Gain - Class 10 [(1/2)($25,000 - $20,000)] | 2,500 |
| Decrease In Net Income For Tax Purposes | ($59,000) |

Note that detailed coverage of capital gains is available in Chapter 8 of the text.

## Self Study Solution Five - 3

### 2016 Solution

The required calculations are as follows:

| | |
|---|---|
| Opening Balance | Nil |
| Additions To Class 10 [(20 Cars)($21,500)] | $430,000 |
| One-Half Net Additions [(1/2)($430,000)] | ( 215,000) |
| CCA Base | $215,000 |
| CCA [(30%)($215,000)(122/365)] | ( 21,559) |
| One-Half Net Additions | 215,000 |
| Class 10 UCC For January 1, 2017 | $408,441 |

As the business was established on September 1, 2016, its operations were carried out for 122 days in 2016, and only a proportionate share of the annual CCA charge may be taken. We would call your attention to the fact that it is the length of the taxation year, not the period of ownership of the assets, that establishes the fraction of the year for which CCA is to be recorded.

***2017 Solution***

The required calculations are as follows:

| | |
|---|---|
| Opening Balance For Class 10 | $408,441 |
| Additions [(6 Cars)($22,800)] | 136,800 |
| Dispositions - Lesser Of: | |
| • Capital Cost = 6 @ $21,500 = $129,000 | |
| • Proceeds Of Disposition = 6 @ $11,400 = $68,400 | ( 68,400) |
| One-Half Net Additions [(1/2)($136,800 - $68,400)] | ( 34,200) |
| CCA Base | $442,641 |
| CCA [(30%)($442,641)] | ( 132,792) |
| One-Half Net Additions | 34,200 |
| Class 10 UCC For January 1, 2018 | $344,049 |

***2018 Solution***

With respect to Class 10 cars, the required calculations are as follows:

| | |
|---|---|
| Opening Balance For Class 10 | $344,049 |
| Additions [(18 Cars)($24,300)] | 437,400 |
| Dispositions - Lesser Of: | |
| • Capital Cost = 14 @ $21,500 = $301,000 | |
| • Proceeds Of Disposition = $137,200 | ( 137,200) |
| One-Half Net Additions [(1/2)($437,400 - $137,200)] | ( 150,100) |
| CCA Base | $494,149 |
| CCA [(30%)($494,149)] | ( 148,245) |
| One-Half Net Additions | 150,100 |
| Class 10 UCC For January 1, 2019 | $496,004 |

With respect to the BMW convertibles, each would have to be allocated to a separate Class 10.1. Further, the addition to each Class 10.1 would be limited to $30,000. The required calculations would be as follows:

| | **BMW 1 Class 10.1** | **BMW 2 Class 10.1** |
|---|---|---|
| Acquisitions | $30,000 | $30,000 |
| One-Half Net Additions | ( 15,000) | ( 15,000) |
| CCA Base | $15,000 | $15,000 |
| CCA [(30%)($15,000)] | ( 4,500) | ( 4,500) |
| One-Half Net Additions | 15,000 | 15,000 |
| UCC For January 1, 2019 | $25,500 | $25,500 |

***2019 Solution***

The required calculations for the Class 10 vehicles are as follows:

| | |
|---|---|
| Opening Balance For Class 10 | $496,004 |
| Dispositions - Lesser Of: | |
| • Capital Cost = 18 @ $24,300 + 6 @ $22,800 = $574,200 | |
| • Proceeds Of Disposition = 24 @ $8,300 = $199,200 | ( 199,200) |
| Balance Before Terminal Loss | $296,804 |
| Terminal Loss | ( 296,804) |
| UCC For January 1, 2020 | Nil |

After all of the assets in Class 10 have been retired there is still a $296,804 balance in the UCC. This results in a terminal loss that will be deducted in full from the Haddad brothers' other income. How this deduction will be shared by the two brothers will depend on the terms of their partnership agreement for the delivery business. The terminal loss will also be deducted from the UCC balance.

With respect to the two Class 10.1 assets, no recapture or terminal losses can be recorded on these assets. However, in the year of disposal, taxpayers are allowed to deduct one-half year of CCA. Given the short fiscal final year, this means that on each of the Class 10.1 vehicles there would be a CCA deduction of $2,861 [(1/2)(30%)($25,500)(273/365)] for a total of $5,722.

## Self Study Solution Five - 4

### *Part A*

The maximum CCA for the 3 years would be calculated as follows:

| 2017 | Class 1 | Class 10 | Class 8 |
|---|---|---|---|
| Opening Balance | Nil | Nil | Nil |
| Additions | $180,000 | $150,000 | $48,000 |
| One-Half Net Additions | ( 90,000) | ( 75,000) | ( 24,000) |
| CCA Base | $ 90,000 | $ 75,000 | $24,000 |
| Maximum CCA | | | |
| Class 1 [(6%)($90,000)(275 ÷ 365)]* | ( 4,068) | | |
| Class 10 [(30%)($75,000)(275 ÷ 365)] | | ( 16,952) | |
| Class 8 [(20%)($24,000)((275 ÷ 365)] | | | ( 3,616) |
| One-Half Net Additions | 90,000 | 75,000 | 24,000 |
| January 1, 2018 UCC | $175,932 | $133,048 | $44,384 |

*As the Class 1 building is being used 100 percent for non-residential purposes, it would qualify for the 6 percent CCA rate.

The total maximum CCA for 2017 would be $24,636 ($4,068 + $16,952 + $3,616).

| 2018 | Class 1 | Class 10 | Class 8 |
|---|---|---|---|
| Beginning UCC | $175,932 | $133,048 | $44,384 |
| Additions | Nil | 72,000 | Nil |
| Disposition - Lesser Of: | | | |
| Capital Cost = $75,000 | | | |
| Proceeds = [(3)($14,000)] = $42,000 | Nil | ( 42,000) | Nil |
| One-Half Net Additions | | | |
| [(1/2)($72,000 - $42,000)] | Nil | ( 15,000) | Nil |
| CCA Base | $175,932 | $148,048 | $44,384 |
| Maximum CCA | | | |
| Class 1 [(6%)($175,932) | ( 10,556) | | |
| Class 10 [(30%)($148,048)] | | ( 44,414) | |
| Class 8 [(20%)($44,384)] | | | ( 8,877) |
| One-Half Net Additions | Nil | 15,000 | Nil |
| January 1, 2019 UCC | $165,376 | $118,634 | $35,507 |

The total maximum CCA for 2018 would be $63,847 ($10,556 + $44,414 + $8,877).

| 2019 | Class 1 | Class 10 | Class 10.1 | Class 8 |
|---|---|---|---|---|
| Beginning UCC | $165,376 | $118,634 | Nil | $35,507 |
| Additions (Class Maximum)* | Nil | Nil | $30,000 | Nil |
| Class 10 Disposition - Lesser Of: | | | | |
| Capital Cost = $25,000 | | | | |
| Proceeds = $27,000 | N/A | ( 25,000) | N/A | N/A |
| Class 8 Dispositions - Lesser Of: | | | | |
| Capital Cost = $12,000 | | | | |
| Proceeds = Nil | N/A | N/A | N/A | Nil |
| AccII Adjustment | | | | |
| [(50%)($30,000)] | N/A | N/A | 15,000 | N/A |
| Balance | $165,376 | $ 93,634 | $45,000 | $35,507 |
| Maximum CCA | | | | |
| Class 1 [(6%)($165,376)] | ( 9,923) | | | |
| Class 10 [(30%)($93,634)] | | ( 28,090) | | |
| Class 10.1 [(30%)($45,000)] | | | ( 13,500) | |
| Class 8 [(20%)($35,507)] | | | | ( 7,101) |
| AccII Adjustment Reversal | N/A | N/A | ( 15,000) | N/A |
| January 1, 2020 UCC | $155,453 | $ 65,544 | $16,500 | $28,406 |

*Additions to Class 10.1 limited to $30,000.

The total maximum CCA for 2019 would be $58,614 ($9,923 + $28,090 + $13,500 + $7,101).

### *Part B*

The tax effects of the unusual events would be as follows:

**Theft Of Equipment** This is, in effect, a disposition with nil proceeds. There will be no immediate tax effect as the equipment is not the last asset in the class.

**Insurance Deductible** The $7,770 in insurance proceeds would be included in income [ITA 12(1)(f)], and the full repair expenses of $8,270 would be a deductible expense. This results in the $500 in repairs that were not covered under the Company's insurance policy being deducted as a repair or maintenance charge.

**Car Sale** As the car was sold for $2,000 more than its capital cost, there would be a capital gain of $2,000, resulting in a taxable capital gain of $1,000 [(1/2)($2,000)]. However, as there is still a balance in the class at the end of the year, no recapture would be recorded.

## Self Study Solution Five - 5

### *Case One*

For the year ending December 31, 2019, the maximum CCA, as well as the UCC balance for January 1, 2020 for Traxit's Class 14.1 would be as calculated as follows:

| | |
|---|---|
| January 1, 2019 Balance | Nil |
| 2019 Additions ($56,000 + $124,000) | $180,000 |
| AccII Adjustment [(50%)($180,000)] | 90,000 |
| CCA Base | $270,000 |
| 2019 CCA [(5%)($270,000)] | ( 13,500) |
| AccII Adjustment Reversal | ( 90,000) |
| January 1, 2020 UCC | $166,500 |

The results for 2020 would be calculated as follows:

| | |
|---|---|
| January 1, 2020 UCC | $166,500 |
| Disposition - Lesser Of: | |
| Capital Cost = $180,000 | |
| Proceeds Of Disposition = $97,000 | ( 97,000) |
| CCA Base | $ 69,500 |
| 2020 CCA [(5%)($69,500)] | ( 3,475) |
| January 1, 2021 UCC | $ 66,025 |

There would be no immediate tax consequences resulting from the sale of goodwill, other than a reduction in the UCC. Note that the capital cost in the calculation is of the single goodwill property.

***Case Two***

For the year ending December 31, 2019, the maximum CCA, as well as the UCC balance for January 1, 2020 for Traxit's Class 14.1 would be as calculated as follows:

| | |
|---|---|
| January 1, 2019 Balance | Nil |
| 2019 Additions ($34,000 + $47,000) | $ 81,000 |
| AccII Adjustment [(50%)($81,000)] | ( 40,500) |
| CCA Base | $121,500 |
| 2019 CCA [(5%)($121,500)] | ( 6,075) |
| AccII Adjustment Reversal | ( 40,500) |
| January 1, 2020 UCC | $ 74,925 |

The results for 2020 would be calculated as follows:

| | |
|---|---|
| January 1, 2020 UCC | $74,925 |
| Disposition - Lesser Of: | |
| Capital Cost = $81,000 | |
| Proceeds Of Disposition = $85,000 | ( 81,000) |
| Negative Ending Balance | ($ 6,075) |
| Recapture Of CCA | 6,075 |
| January 1, 2021 UCC | Nil |

| | |
|---|---|
| Proceeds Of Disposition | $85,000 |
| Capital Cost | ( 81,000) |
| Capital Gain | $ 4,000 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain | $ 2,000 |

There would be an increase in Net Income For Tax Purposes of $8,075 ($6,075 + $2,000).

## Self Study Solution Five - 6

***Class 1 - Buildings (Existing And Separate Class)***

As the new building has been allocated to a separate Class 1, two calculations are required here. The CCA on the existing Class 1 would be as follows:

| | |
|---|---|
| Opening UCC Balance | $590,000 |
| Disposition - Lesser Of: | |
| Proceeds = $290,000 ($440,000 - $150,000) | |
| Capital Cost = $300,000 ($475,000 - $175,000) | ( 290,000) |
| CCA Base | $300,000 |
| CCA Rate | 4% |
| Maximum CCA | $ 12,000 |

Since the replacement building is new, used 100 percent for non-residential purposes and allocated to a separate Class 1, it qualifies for an enhanced CCA rate. As it is not used for manufacturing and processing, the enhanced rate is 6 percent. Using this rate, the CCA on the new building would be as follows:

| | |
|---|---|
| Opening UCC Balance | Nil |
| Additions ($500,000 - $125,000) | $375,000 |
| AccII Adjustment [(50%)($375,000)] | 187,500 |
| CCA Base | $562,500 |
| CCA Rate | 6% |
| Maximum CCA | $ 33,750 |

### *Class 8 - Furniture*

The required calculation here would be as follows:

| | |
|---|---|
| Opening UCC Balance | $570,000 |
| Additions | 14,000 |
| AccII Adjustment [(50%)($14,000)] | 7,000 |
| CCA Base | $591,000 |
| CCA Rate | 20% |
| Maximum CCA | $118,200 |

### *Class 10 - Vehicles*

The required calculations here would be as follows:

| | |
|---|---|
| Opening UCC Balance | $61,000 |
| Additions | 22,000 |
| AccII Adjustment* | Nil |
| CCA Base | $83,000 |
| CCA Rate | 30% |
| Maximum CCA | $24,900 |

*As the acquired truck was a depreciable property (it had a UCC balance) transferred from a non-arm's length person, the AccII provisions do not apply to this acquisition. The shareholder's UCC does not affect the CCA calculations for Bartel Ltd.

### *Summary (Not Required)*

The maximum CCA is as follows:

| | |
|---|---|
| Class 1 | $ 12,000 |
| Class 1 | 33,750 |
| Class 8 | 118,200 |
| Class 10 | 24,900 |
| Maximum CCA | $188,850 |

## Self Study Solution Five - 7

### *Class 1 - Building*

There were no additions or dispositions in this class. As a consequence, the maximum 2019 CCA would be $25,000 [(4%)($625,000)]. The January 1, 2020 UCC of Class 1 would be $600,000 ($625,000 - $25,000).

### *Class 8 - Office Furniture And Equipment*

The required calculations for this class would be as follows:

| | | |
|---|---|---|
| Opening UCC Balance | | $155,000 |
| Additions | $27,000 | |
| Dispositions - Lesser Of: | | |
| • Capital Cost = $22,000 | | |
| • Proceeds Of Disposition = $35,000 | ( 22,000) | 5,000 |
| AccII Adjustment [(50%)($5,000)] | | 2,500 |
| CCA Base | | $162,500 |
| 2019 CCA [(20%)($162,500)] | | ( 32,500) |
| AccII Adjustment Reversal | | ( 2,500) |
| January 1, 2020 UCC Balance | | $127,500 |

The sale of the furniture and equipment would result in a taxable capital gain that would be calculated as follows:

| | |
|---|---|
| Proceeds Of Disposition | $35,000 |
| Capital Cost | ( 22,000) |
| Capital Gain | $13,000 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain | $ 6,500 |

### *Class 10 - Vehicles*

The required calculations for this class would be as follows:

| | | |
|---|---|---|
| Opening UCC Balance | | $118,000 |
| Additions | $33,000 | |
| Disposition of Truck - Lesser Of: | | |
| • Capital Cost = $23,000 | | |
| • Proceeds Of Disposition = $8,500 | ( 8,500) | |
| Disposition of Car - Lesser Of: | | |
| • Capital Cost = $17,000 | | |
| • Proceeds Of Disposition = $8,000 | ( 8,000) | 16,500 |
| AccII Adjustment [(50%)($16,500)] | | 8,250 |
| CCA Base | | $142,750 |
| 2019 CCA [(30%)($142,750)] | | ( 42,825) |
| AccII Adjustment Reversal | | ( 8,250) |
| January 1, 2020 UCC Balance | | $ 91,675 |

Note that the amount received from the insurance company on the destroyed vehicle is treated as proceeds from a disposition.

### Class 12 - Tools

Tools that cost $500 or less are allocated to Class 12 where they are not subject to the half-year rule or the AccII provisions. This means that they are eligible for a write-off rate of 100 percent in the year of acquisition. As a consequence, the entire $34,000 can be deducted as CCA for 2019, leaving a nil January 1, 2020 UCC balance.

### Class 13 - Leasehold Improvements

In general, leasehold improvements will be written off over the term of the lease on a straight line basis. For purposes of applying this calculation, the term of the lease would include the first renewal option, beginning in a period after the improvements were made. In the case of the original improvements, the period to be used is 12 years. With respect to the improvements during the current year, the write-off period will be 9 years. Also note that Class 13 assets are eligible for the AccII provisions on net additions. The required calculations are as follows:

| | | |
|---|---|---|
| Opening UCC Balance | | $ 61,750 |
| Additions | | 45,000 |
| CCA Base | | $106,750 |
| CCA: | | |
| • 2016 Improvements ($78,000 ÷ 12) | ($6,500) | |
| • 2019 Improvements Including AccII Adjustment [($45,000 ÷ 9)(150%)] | ( 7,500) | ( 14,000) |
| January 1, 2020 UCC Balance | | $ 92,750 |

### Class 14.1 - Intangible Assets

The required calculations for this Class are as follows:

| | |
|---|---|
| Opening UCC Balance | Nil |
| Disposition - Lesser Of: | |
| • Capital Cost = Nil | |
| • Proceeds Of Disposition = $87,000 | Nil |
| January 1, 2020 UCC Balance | Nil |

| | |
|---|---|
| Proceeds Of Disposition | $87,000 |
| Capital Cost | Nil |
| Capital Gain | $87,000 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain | $43,500 |

### Class 50 - Computer Hardware

The required calculations are as follows:

| | |
|---|---|
| Opening UCC Balance | $ Nil |
| Additions | 28,000 |
| AccII Adjustment [(50%)($28,000)] | 14,000 |
| CCA Base | $42,000 |
| 2019 CCA [(55%)($42,000)] | ( 23,100) |
| AccII Adjustment Reversal | ( 14,000) |
| January 1, 2020 UCC Balance | $ 4,900 |

### *Class 53 - Manufacturing Equipment*

The required calculations are as follows:

| | |
|---|---|
| Opening UCC Balance | $217,000 |
| Dispositions - Lesser Of: | |
| • Capital Cost = $752,000 | |
| • Proceeds Of Disposition = $188,000 | ( 188,000) |
| Ending Balance With No Remaining Assets In Class | $ 29,000 |
| Terminal Loss | ( 29,000) |
| January 1, 2020 UCC Balance | Nil |

After all of the assets in Class 53 have been retired there is still a $29,000 UCC balance. This results in a terminal loss that will be deducted in full from the Net Income of Atlantic Manufacturing Company.

### *Other Income Effects*

In addition, the following income effects resulted from the information provided in the problem:

| | |
|---|---|
| Taxable Capital Gain On Class 8 Assets | $ 6,500 |
| Taxable Capital Gain On Class 14.1 Assets | 43,500 |
| Terminal Loss On Class 53 Assets | ( 29,000) |
| Total Inclusion | $21,000 |

### *Summary Of CCA And UCC Results (Not Required)*

The maximum 2019 CCA and the January 1, 2020 UCC balances can be summarized as follows:

| | Maximum CCA | UCC |
|---|---|---|
| Class 1 | $ 25,000 | $600,000 |
| Class 8 | 32,500 | 127,500 |
| Class 10 | 42,825 | 91,675 |
| Class 12 | 34,000 | Nil |
| Class 13 | 14,000 | 92,750 |
| Class 14.1 | Nil | Nil |
| Class 50 | 23,100 | 4,900 |
| Class 53 | Nil | Nil |

## Self Study Solution Five - 8

### *Part A*

The required calculation of the maximum CCA is as follows:

| | |
|---|---|
| Class 8 [(20%)($163,000)] | $ 32,600 |
| Class 10 (Note 1) | 43,950 |
| Class 12 (Note 2) | 42,000 |
| Class 13 (Note 3) | 24,000 |
| Class 14.1 [(7%)($132,330)] (Note 4) | 9,263 |
| Maximum Total | $151,813 |

**Note 1** The Class 10 CCA would be calculated as follows:

| | |
|---|---|
| Opening Balance | $112,000 |
| Additions | 52,000 |
| Proceeds Of Disposition (Less Than Cost) | ( 29,000) |
| AccII Adjustment [(1/2)($52,000 - $29,000)] | 11,500 |
| CCA Base | $146,500 |
| CCA Rate | 30% |
| Maximum CCA | $ 43,950 |

**Note 2** The rate for Class 12 is 100 percent. However, some additions to this Class are subject to the half-year rules. The presence of an opening balance of $42,000 and the statement that maximum CCA has always been taken, indicates that there must have been $84,000 of costs in 2018 that were subject to this rule. Given this, the entire balance can be deducted in 2019.

**Note 3** The $204,000 balance in Class 13 is equal to 85 percent of $240,000. This means that during the two years 2017 and 2018, 15 percent of their cost was deducted as CCA. As the half-year rules are applicable to this Class, this represents a half year for 2017 and a full year for 2018. Since Class 13 is a straight-line Class, this indicates that the CCA rate is 10 percent (15% ÷ 1.5). Based on this analysis, maximum CCA for 2019 would be $24,000 [(10%)($240,000)].

**Note 4** While the basic rate for Class 14.1 is 5 percent, the transitional rules allow continued use of the old CEC rate of 7 percent on balances carried forward from 2016. The use of this rate is available through 2026.

### *Part B*

Since the Company only has Net and Taxable Income before CCA of $43,000 and the problem states that loss carry overs should not be considered, maximum CCA would not be deducted. Only $43,000 in CCA should be taken in order to reduce the Taxable Income to nil.

As to which CCA Classes should be reduced, the usual procedure is to deduct the required amount from the balances with the lowest rates. By leaving the balances with higher rates untouched, larger amounts of CCA can be deducted in later periods as required.

Taking this approach, the recommended CCA would be as follows:

| | |
|---|---|
| Class 14.1 (Maximum Available) | $ 9,263 |
| Class 13 (Maximum Available) | 24,000 |
| Class 8 ($43,000 - $9,263 - $24,000) | 9,737 |
| Total CCA | $43,000 |

The deduction of this amount of CCA would serve to reduce Taxable Income to nil.

## Chapter 5 Learning Objectives

After completing Chapter 5, you should be able to:

1. Describe the differences between the accounting procedures used for depreciable assets and the tax procedures used for these assets (paragraph [P hereafter] 5-1 to 5-11).
2. Determine the types of costs that are included in the amounts that are added to depreciable asset classes (P 5-12 to 5-25).
3. Recall the basic available for use rules (P 5-26 to 5-28).
4. Recall the general rules for segregating depreciable assets into classes (P 5-29 to 5-31).
5. Recall the types of assets that must be allocated to separate classes (P 5-32).

6. Explain the basic elements of the CCA system (P 5-33 to 5-35).
7. Apply the rates and methods that are applicable to common CCA classes in order to determine the maximum CCA for the period (P 5-36).
8. Describe the half-year rules in the determination of maximum CCA for the period (P 5-37 to 5-38).
9. Describe the Accelerated Investment Incentive (AccII) (P 5-39 to 5-54).
10. Describe the application of the AccII to Classes 12, 13, 14 and 53 (P 5-55 to 5-60).

11. Describe the enhanced CCA provisions for zero emission vehicles in Class 54 and 55 (P 5-61 to 5-67).
12. Apply the short fiscal period rules in the determination of maximum CCA for the period (P 5-68 to 5-70).
13. Describe the additions to Class 14.1 and the special treatment for goodwill and the December 31, 2016 CEC balance (P 5-71 to 5-85).
14. Explain the tax planning considerations that are involved when a business takes less than maximum CCA (P 5-86 to 5-90).
15. Determine the tax consequences associated with dispositions of depreciable assets, including recapture, terminal losses, and capital gains (P 5-91 to 5-108).

16. Explain the special disposition rules applicable to Class 54 (P 5-109 to 5-111).
17. Explain how the treatment of dispositions in Class 14.1 differs from that for other CCA classes (P 5-112 to 5-122).
18. Create the commonly used CCA schedule for a situation with depreciable assets (P 5-123 to 5-124).
19. Apply the provisions relating to separate class elections (P 5-125 to 5-134).
20. Apply the provisions relating to the change in use of automobiles. (P 5-135 to 5-140).
21. Apply the December 31, 2016 CEC to Class 14.1 transitional rules (P 5-141 to 5-175).

# CHAPTER 6

## How To Work Through Chapter 6

We recommend the following approach in dealing with the material in this chapter:

**Overview And Classification Of Business Income**

- Read paragraph 6-1 to 6-16 (in the textbook).

**Business Income Vs. Property Income**

- Read paragraph 6-17 to 6-27.
- Do Exercise Six-1 (in the textbook) and check the solution in this Study Guide.

**Business Income Vs. Capital Gains**

- Read paragraph 6-28 to 6-42.
- Do Exercise Six-2 and check the solution in this Study Guide.

**Business Income And GAAP**

- Read paragraph 6-43 to 6-45.

**Inclusions - Amounts Received And Receivable**

- Read paragraph 6-46 to 6-53.

**Reserves For Doubtful Debts, Undelivered Goods And Unpaid Amounts**

- Read paragraph 6-54 to 6-61.
- Do Exercise Six-3 and check the solution in this Study Guide.
- Read paragraph 6-62.
- Do Exercise Six-4 and check the solution in this Study Guide.
- Read paragraph 6-63.
- Do Exercise Six-5 and check the solution in this Study Guide.
- Do Self Study Problems Six-1 and Six-2 which are available on MyLab and check the solutions in this Study Guide.

**Other Inclusions**

- Read paragraph 6-64 to 6-65.

**Limitations On Deductions From Business And Property Income, Including Work Space In The Home Costs**

- Read paragraph 6-66 to 6-93.
- Do Exercise Six-6 and check the solution in this Study Guide.
- Read paragraph 6-94 to 6-100.
- Do Exercise Six-7 and check the solution in this Study Guide.
- Do Self Study Problem Six-3 and check the solution in this Study Guide.
- Read paragraph 6-101 to 6-103.

**Limitations On Deductions From Business, Property, And Employment Income, Including Reasonableness, Meals And Entertainment**

- Read paragraph 6-104 to 6-112.

**Restrictions On Automobile Costs**

- Read paragraph 6-113 to 6-118
- Do Exercise Six-8 and check the solution in this Study Guide.
- Read paragraph 6-119 to 6-126.
- Do Exercise Six-9 and check the solution in this Study Guide.
- Do Self Study Problems Six-4 to Six-6 and check the solutions in this Study Guide.

**Leasing Property**

- Read paragraph 6-127 to 6-129.
- Do Exercise Six-10 and check the solution in this Study Guide.

**Illegal Payments, Fines And Penalties**

- Read paragraph 6-130 and 6-132.

**Specific Deductions From Business Income, Including Cost Of Sales**

- Read paragraph 6-133 to 6-141.
- Do Exercise Six-11 and check the solution in this Study Guide.
- Do Self Study Problem Six-7 and check the solution in this Study Guide.
- Read paragraph 6-142 to 6-143.

**Reconciliation Of Accounting Net Income And Net Income For Tax Purposes**

- Read paragraph 6-144 to 6-149.
- Do Self Study Problems Six-8 to Six-10 and check the solutions in this Study Guide.

**Taxation Year And Additional Business Income**

- Read paragraph 6-150 to 6-157.
- Do Exercise Six-12 and check the solution in this Study Guide.
- Do Self Study Problem Six-11 and check the solution in this Study Guide.

**Farming Income And Losses, Including Restricted Farm Losses**

- Read paragraph 6-158 to 6-164.
- Do Exercise Six-13 and check the solution in this Study Guide.
- Read paragraph 6-165 to 6-169.

**Professional Income (Billed Basis Of Recognition And Change in Legislation)**

- Read paragraph 6-170 to 6-174.
- Do Exercise Six-14 and check the solution in this Study Guide.
- Do Self Study Problems Six-12 and Six-13 and check the solutions in this Study Guide.

**Sale Of A Business, Including ITA 22 Election On Accounts Receivable**

- Read paragraph 6-175 to 6-180.
- Do Exercise Six-15 and check the solution in this Study Guide.
- Do Self Study Problem Six-14 to Six-16 and check the solutions in this Study Guide.
- Read paragraph 6-181.

**To Complete This Chapter**

- If you would like more practice in problem solving, do the Supplementary Self Study Problems for the chapter. These problems and solutions are available on MyLab.
- Review the Key Terms Used In This Chapter in the textbook at the end of Chapter 6. Consult the Glossary for the meaning of any key terms you do not know.
- Test yourself with the Chapter 6 Glossary Flashcards available on MyLab.
- Ensure you have achieved the Chapter 6 Learning Objectives listed in this Study Guide.

- As a review, we recommend you view the PowerPoint presentation for Chapter 6 that is on MyLab.

**Practice Examination**

- Write the Practice Examination for Chapter 6 that is on MyLab. Mark your examination using the Practice Examination Solution that is also on MyLab.

## Solutions to Chapter Six Exercises

***Exercise Six - 1 Solution***

With a single transaction, Joan's activity clearly does not fall within the general definition of operating a business. However, the real question is whether this transaction would be considered an adventure or concern in the nature of trade. As she is not behaving like a dealer and does not appear to have an intent to sell the song rights, it is unlikely that this transaction would be viewed as an adventure or concern in the nature of trade. This means that the royalties would be treated as property income, rather than business income. While this classification would not be important as long as she holds the rights, if there is a disposition of these rights, any gain would be treated as a capital gain, rather than as a fully taxable business gain.

***Exercise Six - 2 Solution***

Provided that she can demonstrate that her intent was to operate the building as a rental property, the gain should qualify as a capital gain. The fact that the offer was unsolicited would support this conclusion.

***Exercise Six - 3 Solution***

The Bad Debt Expense would be as follows:

| | |
|---|---|
| 2019 Estimate Of Future Bad Debts (Credit Allowance) | ($18,400) |
| Increase In Expense To Eliminate Debit Balance In Allowance ($17,200 Actual Write-Offs - $16,000 Allowance) | ( 1,200) |
| 2019 Bad Debt Expense For Accounting Purposes | ($19,600) |

For tax purposes, the net decrease for the year will be the same $19,600 calculated as follows:

| | | |
|---|---|---|
| Add: 2018 Reserve For Tax Purposes | | $ 16,000 |
| Deduct: | | |
| 2019 Actual Write-Offs | ($17,200) | |
| 2019 Reserve For Tax Purposes | ( 18,400) | ( 35,600) |
| 2019 Net Deduction For Tax Purposes | | ($19,600) |

***Exercise Six - 4 Solution***

The amount to be included in net business income would be calculated as follows:

| | |
|---|---|
| Cash Sales | $53,400 |
| Accounts Receivable | 26,300 |
| Reserve For Undelivered Services | ( 5,600) |
| Reserve For Doubtful Accounts | ( 425) |
| Total Increase | $73,675 |

***Exercise Six - 5 Solution***

As some of the proceeds are not receivable for more than two years after the date of sale, a reserve can be deducted under ITA 20(1)(n) for the years 2019, 2020, and 2021. As

December 31, 2022 is more than 36 months after the sale was made, no reserve can be deducted for 2022 or 2023. Note that the previous year's reserve is added to income before deducting the new reserve. The maximum reserve is based on the gross profit of $65,000. None of this profit will be recognized in 2019 as no proceeds are received. In 2020 and 2021, 25 percent of the profit will be recognized, with the remainder being in 2022 when no reserve can be deducted.

The maximum reserve that can be deducted in each year, as well as the minimum income to be recognized in each year, is shown in the following schedule:

| | Income | Proceeds Rec'd |
|---|---|---|
| 2019 Reserve = [(100%)($65,000)] = $65,000 | Nil | Nil |
| 2020 Reserve = [(75%)($65,000)] = $48,750 | $16,250 | $ 30,000 |
| 2021 Reserve = [(50%)($65,000)] = $32,500 | 16,250 | 30,000 |
| 2022 Reserve = Nil (>36 Months From Sale) | 32,500 | 30,000 |
| 2023 Reserve = Nil (All Proceeds Received) | Nil | 30,000 |
| Totals | $65,000 | $120,000 |

Note that the technically correct calculation of income involves adding back the previous year's reserve and deducting the new reserve. For example, the calculation for 2021 involves adding back the 2020 reserve of $48,750 and deducting the new reserve of $32,500 to calculate the income of $16,250 ($48,750 - $32,500).

### *Exercise Six - 6 Solution*

As Ms. Johnson owns 30 percent of the common shares, she is clearly a specified shareholder under ITA 18(5). Her relevant equity balance would be $1,620,000 [(30%)($2,400,000) + (100%)($900,000)]. Given this, the disallowed interest would be calculated as follows:

| | |
|---|---|
| Total Interest Paid To Ms. Johnson [(9%)($4,500,000)] | $405,000 |
| Maximum Deductible Interest [(9%)(1.5)($1,620,000)] | ( 218,700) |
| Disallowed Interest | $186,300 |

### *Exercise Six - 7 Solution*

The following work space in the home costs would be deductible in each of the three scenarios:

| | Part A | Part B | Part C |
|---|---|---|---|
| Utilities | $2,400 | $ 2,400 | $ 2,400 |
| Maintenance And Repairs | 4,600 | 4,600 | 4,600 |
| Property Taxes | Nil | 5,200 | 5,200 |
| House Insurance | Nil | 2,300 | 2,300 |
| Interest On Mortgage | Nil | Nil | 7,800 |
| House CCA | Nil | Nil | 12,000 |
| Subtotal | $7,000 | $14,500 | $34,300 |
| Percentage | 25% | 25% | 25% |
| Subtotal | $1,750 | $ 3,625 | $ 8,575 |
| Repainting And Rewiring (100%) | 1,000 | 1,000 | 1,000 |
| Internet Service Fees [(95%)($960)] | Nil | Nil | 912 |
| Monthly Phone [(95%)($600)] | Nil | Nil | 570 |
| Long Distance Charges (100%) | 390 | 390 | 390 |
| Maximum Deduction | $3,140 | $ 5,015 | $ 11,447 |

### Exercise Six - 8 Solution

With respect to the amount of CCA, since the business commenced operations on September 15, 2019, the CCA is limited to the proportion of the year the business was in operation (108/365) and the AccII provisions would apply. The fact that the car was purchased on October 1 does not affect the short fiscal year calculation.

The base amount for the CCA calculation is limited to the Class 10.1 maximum of $30,000. With respect to the interest, the car was financed for a total of 92 days with a limit of $10 per day. As a result, the amounts that can be deducted are as follows:

| | |
|---|---|
| CCA [(150%)(108/365)(30%)($30,000)] | $3,995 |
| Interest Costs - Lesser Of: | |
| • Amount Paid = $1,200 | |
| • [($10)(92 Days)] = $920 | 920 |
| Total Deduction | $4,915 |

### Exercise Six - 9 Solution

The amount he can deduct is limited to $2,229, the least of:

- $4,925 [($985)(5)];
- $4,080 [($800)(153/30)]; and
- $2,229 {[$4,925][$30,000 ÷ (85%)($78,000)]}.

### Exercise Six - 10 Solution

For tax purposes, the lease would be treated as an operating lease, with the deduction being based only on the lease payments. Under GAAP, the lease would have to be treated as a purchase and capitalized. This is because during the lease term the lease transfers "substantially all of the benefits and risks of ownership related to the leased property from the lessor to the lessee". This means that the accounting deductions would be for amortization on the capitalized asset and interest costs on the associated liability.

### Exercise Six - 11 Solution

The average per unit cost of $2.87 ($663,850 ÷ 231,000) is calculated as follows:

| Price | Units | Total |
|---|---|---|
| $2.50 | 50,000 | $125,000 |
| $2.85 | 35,000 | 99,750 |
| $2.95 | 62,000 | 182,900 |
| $3.05 | 84,000 | 256,200 |
| Totals | 231,000 | $663,850 |

The following calculations will be used in this solution.

| | |
|---|---|
| Fair Market Value (Using Replacement Cost) [($3.10)(102,000)] | $316,200 |
| Fair Market Value (Using Net Realizable Value) [(90%)($4.50)(102,000)] | 413,100 |
| FIFO Cost [(84,000)($3.05) + (102,000 - 84,000)($2.95)] | 309,300 |
| Average Cost [($2.87)(102,000)] | 292,740 |

For tax purposes, the inventory value can be determined by any of the following methods.

| | |
|---|---|
| Fair Market Value = Replacement Cost | $316,200 |
| Fair Market Value = Net Realizable Value | 413,100 |
| Lower of FIFO Cost ($309,300) or Replacement Cost ($316,200) | 309,300 |
| Lower of FIFO Cost ($309,300) or Net Realizable Value ($413,100) | 309,300 |
| Lower of Average Cost ($292,740) or Replacement Cost ($316,200) | 292,740 |
| Lower of Average Cost ($292,740) or Net Realizable Value ($413,100) | 292,740 |

### *Exercise Six - 12 Solution*

Mr. Gelato's additional business income for 2019 will be $18,551 [($12,300)(184 Days ÷ 122 Days)]. The 184 days is for the period July 1 through December 31, while the 122 days is for the period March 1 through June 30. The total business income that Mr. Gelato will have to report for 2019 is $30,851 ($12,300 + $18,551).

### *Exercise Six - 13 Solution*

For Ms. Morph, farming is clearly a secondary source of income. Given this, her farm losses will be restricted. The amount she can deduct for 2019 will be limited to $10,600 [$2,500 + (1/2)($18,700 - $2,500)]. The remaining $8,100 ($18,700 - $10,600) restricted farm loss is available for carry over.

### *Exercise Six - 14 Solution*

Mr. Winters' income inclusion for the year ending December 31, 2019 would be calculated as follows:

| | |
|---|---|
| January 1, 2019 Unbilled Work In Process [(100% - 20%)($35,000)] | $ 28,000 |
| Billings For Work Done In 2019 | 185,000 |
| December 2019 Unbilled Work In Process [(40%)($245,000 - $185,000)] | 24,000 |
| Total 2019 Income Inclusion | $237,000 |

Mr. Winters' income inclusion for the year ending December 31, 2020 would be calculated as follows:

| | |
|---|---|
| Unrecognized Work In Process From 2019 [(100% - 40%)($245,000 - $185,000)] | $ 36,000 |
| Billings For Work Done In 2020 | 247,000 |
| December 2020 Unbilled Work In Process [(60%)($285,000 - $247,000)] | 22,800 |
| Total 2020 Income Inclusion | $305,800 |

### *Exercise Six - 15 Solution*

Mr. Nero would include in his business income the 2018 reserve of $3,800. He could then deduct the $5,250 ($53,450 - $48,200) loss on the receivables. The net tax effect for Mr. Nero would be a deduction in the determination of business income of $1,450 ($5,250 - $3,800).

Mr. Labelle would have to include the $5,250 difference between the face value and the price paid in income. Subsequent to the sale, 100 percent of any difference between the $53,450 face value of the receivables and amounts actually collected will be deductible when calculating Mr. Labelle's net business income.

Mr. Labelle could establish a new reserve for doubtful debts related to any uncollected receivables that are outstanding at the end of the year.

## Self Study Solution Six - 1

The net deduction for bad debts in the calculation of 2019 business income would be calculated as follows:

| | |
|---|---|
| Add: | |
| 2018 Reserve For Doubtful Debts | $11,500 |
| Recoveries Of 2018 Bad Debts During 2019 | 1,500 |
| Deduct: | |
| Actual Bad Debt Write-Offs During 2019 ($8,800 - $700) | ( 8,100) |
| 2019 Reserve For Doubtful Debts ($15,900 + $700) | ( 16,600) |
| 2019 Net Deduction From Business Income | ($11,700) |

Note that the $700 that was due from Dr. Allworth's personal friend has been treated as part of the reserve for doubtful debts, rather than as part of the write-offs for the period. The $190 recovery in 2018 would have been included in income in 2018 and would not affect 2019 income.

## Self Study Solution Six - 2

The results for the 2 years would be as follows:

| | 2019 | 2020 |
|---|---|---|
| Cash Collections ($259,000 - $88,000) | $171,000 | |
| Cash Collections ($360,000 - $72,000) | | $288,000 |
| Ending Receivables | 88,000 | 72,000 |
| Reserve For Doubtful Debts: | | |
| Add Prior Year Reserve | Nil | 7,000 |
| Deduct Current Year Reserve | ( 7,000) | ( 9,500) |
| Deduct Actual Write-Offs | Nil | ( 6,500) |
| Advances From Customers | 27,000 | 21,000 |
| Reserve For Undelivered Merchandise: | | |
| Add Prior Year Reserve | Nil | 27,000 |
| Deduct Current Year Reserve | ( 27,000) | ( 21,000) |
| Gross Profit On Sale Of Unused Materials | 15,000 | Nil |
| Reserve For Unpaid Amounts: | | |
| Add Prior Year Reserve | | 9,677 |
| Deduct Current Year Reserve* | | |
| {[$15,000][($62,000 - $22,000) ÷ $62,000]} | ( 9,677) | |
| {[$15,000][($62,000 - $42,000) ÷ $62,000]} | | ( 4,839) |
| Net Effect | $257,323 | $382,838 |

*As some of the proceeds on the sale of unused materials are not due until two years after the date of the sale, a reserve for unpaid amounts can be deducted. The three year time limit is not relevant as the full balance is paid off prior to the end of that period.

## Self Study Solution Six - 3

### *Part A*

Under ITA 18(12), the following conditions must be satisfied in order for expenses related to work space in a self-contained domestic establishment to be deductible:

- the work space is either the individual's principal place of business; or
- the work space is used exclusively for the purpose of earning income from business and is used on a regular and continuous basis for meeting clients, customers, or patients of the individual in respect of the business.

With respect to Ms. Hart's mail order business, the allocated space in her home would appear to be her principal place of business. This means that she would be able to deduct work space in home costs in determining her net business income.

***Part B***

The calculation of the minimum net business income to be reported in Veronica's personal tax return is as follows:

| | | |
|---|---|---|
| Revenues | | $89,000 |
| Less: Expenses Other Than Home Work Space Costs: | | |
| Cost Of Merchandise Sold | ($46,000) | |
| Packaging Materials | ( 1,547) | |
| Shipping Costs | ( 3,216) | |
| Miscellaneous Office Supplies | ( 825) | |
| Telephone | ( 210) | |
| Advertising Brochures | ( 156) | |
| CCA (Note 1) | ( 2,056) | ( 54,010) |
| Income Before Home Work Space Costs | | $34,990 |
| Less: Home Work Space Costs (Note 2) | | ( 2,174) |
| Net Business Income | | $32,816 |

**Note 1** Maximum CCA amounts on the assets of the business (not including CCA on the house) for the short fiscal year would be calculated as follows (alternative calculations shown in the two columns):

| | **100%** | **Short Fiscal Year (346/365)** |
|---|---|---|
| Class 8 [($14,000)(1/2)(20%)] | $1,400 | $1,327 |
| Class 50 [($1,350)(1/2)(55%)] | 371 | 352 |
| Class 12 [($795)(1/2)(100%)] | 398 | 377 |
| Total | $2,169 | |
| Short Fiscal Year Factor | 346/365 | |
| Maximum CCA | $2,056 | $2,056 |

**Note 2** The home work space costs would be calculated as follows:

| | |
|---|---|
| Utilities For Home (Heat, Light, And Water) | $ 2,850 |
| Mortgage Interest Paid | 4,183 |
| House Insurance | 400 |
| Property Taxes | 1,230 |
| Repairs And Maintenance For Home | 1,125 |
| Total Out-Of-Pocket Costs | $ 9,788 |
| Class 1 CCA [($355,000 - $80,000)(1/2)(4%)] | 5,500 |
| Total Costs For The Home | $15,288 |
| Percentage Of Floor Space | 15% |
| Subtotal | $ 2,293 |
| Short Fiscal Year Factor | 346/365 |
| Deductible Home Work Space Costs | $ 2,174 |

***Part C***

There are two issues that should be discussed with Veronica.

- As this problem asks for "minimum" net business income, CCA must be deducted on Ms. Hart's home. The problem with this is that, if she takes CCA, it could jeopardize the principal residence exemption on this property, resulting in the payment of taxes on a portion of the taxable capital gain that might arise on any future sale of the property, assuming real estate prices are increasing. This is discussed in more detail in Chapter 8.

- Although it is not relevant for this year, Ms. Hart should be aware that the deduction of work space in home costs cannot be used to create a loss in the future. However, any amount not deductible because it is greater than her income can be deducted in any subsequent year provided there is sufficient income from the same business in that year. This provides for an unlimited carry forward of unused work space in home costs (see S4-F2-C2, *Business Use Of Home Expenses*).

## Self Study Solution Six - 4

### *Part A*

In Part A(i), Ms. Wise is an employee and, because her income includes commissions, she can deduct expenses related to the production of employment income under ITA 8(1)(f), provided no deduction is made under ITA 8(1)(h) or ITA 8(1)(h.1).

Deductions under ITA 8(1)(f) are limited to the amount of commissions earned. Alternatively, traveling costs and motor vehicle costs other than capital costs can be deducted under ITA 8(1)(h) and ITA 8(1)(h.1). Deductions under these provisions are not limited to commission income.

The deduction of dues and other expenses under ITA 8(1)(i) and automobile capital costs (CCA and financing costs) under ITA 8(1)(j) is permitted without regard to other provisions used.

| | ITA 8(1)(f) (Limited To $15,000) | ITA 8(1) (h) and (h.1) | ITA 8(1) (i) and (j) | Part A(ii) |
|---|---|---|---|---|
| Professional Dues | - | - | $ 600 | $ 600 |
| Automobile Costs: | | | | |
| Operating Costs [(35,000/50,000)($6,000)] | $ 4,200 | $ 4,200 | - | 4,200 |
| Financing Costs [(35,000/50,000)($2,500)] | - | - | 1,750 | 1,750 |
| CCA (See Note) | - | - | 5,355 | 5,355 |
| Home Office Costs: | | | | |
| Utilities [(40%)($3,550)] | - | - | 1,420 | 1,420 |
| Maintenance [(40%)($1,500)] | - | - | 600 | 600 |
| Insurance [(40%)($950)] | 380 | - | - | 380 |
| Property Taxes [(40%)($4,700)] | 1,880 | - | - | 1,880 |
| Interest [(40%)($13,500)] | - | - | - | 5,400 |
| CCA [($140,000)(4%)] | - | - | - | 5,600 |
| Travel Costs | 23,000 | 23,000 | - | 23,000 |
| Non-Deductible Meals [(50%)($8,000)] | ( 4,000) | ( 4,000) | - | ( 4,000) |
| Country Club Charges | 12,000 | - | - | 12,000 |
| Non-Deductible Membership Fees | ( 2,500) | - | - | ( 2,500) |
| Non-Deductible Meals [(50%)($9,500)] | ( 4,750) | - | - | ( 4,750) |
| Total | $30,210 | $23,200 | $9,725 | $50,935 |

**Note** The car will be allocated to Class 10.1 at a value of $30,000, the 2018 limit. The excess of $23,000 will not be deductible. Maximum CCA for 2018 (pre-AccII provisions) would have been $4,500 [(30%)(1/2)($30,000)]. The deductible amount for 2018 would have been this amount, multiplied by the portion of her total usage that was related to income producing activity.

The January 1, 2019 UCC would be $25,500 ($30,000 - $4,500) and maximum CCA for 2019 would have been $7,650 [(30%)($25,500)]. Note that, in determining the relevant UCC value, the full amount of maximum 2018 CCA was deducted, not just the portion that was actually deducted in that year. The deductible amount for 2019 equals $5,355 [(35,000/50,000)($7,650)].

The deduction for home office costs has been split between ITA 8(1)(i) and (f). Since the utilities and maintenance portion can be deducted under ITA 8(1)(i), it is not limited by the commission income. The insurance and property tax components are limited as they are deducted under ITA 8(1)(f). A limitation, which is not illustrated in this problem, prevents the deduction of home office costs from creating an employment loss.

As the ITA 8(1)(f) amount is limited to the $15,000 in commission income, the total deduction using ITA 8(1)(f), (i) and (j), is $24,725 ($15,000 + $9,725).

The total deduction using ITA 8(1)(h), (h.1), (i) and (j), is $32,925 ($23,200 + $9,725). Note that when this approach is used, home office costs are limited to utilities and maintenance. Further, there is no deduction for entertainment costs. However, this approach results in deductions totaling $8,200 ($32,925 - $24,725) more than the amount available using ITA 8(1)(f), (i), and (j) due to the effect of the commission income limit.

Comparing Parts A (i) and A (ii), there is a difference of $18,010 ($50,935 - $32,925) between the maximum employee and self-employed calculations, illustrating the importance of the difference between being an employee and being self-employed. This problem is, of course, somewhat unrealistic in that, if Ms. Wise was an employee, it is likely that she would be compensated or reimbursed for at least part of her employment related expenses.

### *Part B*

As will be discussed in Chapter 8, capital gains on an individual's principal residence are, in general, not subject to income taxes. While a strict application of the relevant rules would remove from principal residence status the portion of Ms. Wise's home that was used for income producing activities, the administrative procedures of the CRA do not follow this approach. It appears that, as long as no CCA is taken on the work space portion of the home, 100 percent of the property will qualify as a principal residence. Given this, and the assumption that real estate prices are increasing, it would not be wise for Ms. Wise to take CCA on her office space.

## Self Study Solution Six - 5

### *Part A*

As the lease was entered into in 2018, the 2018 limits on deductibility apply for the life of the lease. The maximum deduction for automobile lease payments for 2018 would be the least of:

- $1,800
- $\left[\$800 \text{ x } \frac{31}{30}\right] - \text{Nil} - \left[(\$10{,}000 - \$1{,}000) \text{ x } 2\% \text{ x} \frac{31}{365}\right] - \$500 = \$311$
- $\left[\$1{,}800 \text{ x} \frac{\$30{,}000}{(85\%)(\$85{,}000)}\right] - \left[(\$10{,}000 - \$1{,}000) \text{ x } 2\% \text{ x} \frac{31}{365}\right] - \$500 = \$232$

The least of the three figures is $232 and this will be the maximum 2018 deduction for Borris Industries.

The maximum deduction for automobile lease payments for 2019 would be the least of:

- $[(\$1,800)(12)] = \$21,600$
- $\left[\$800 \times \frac{396}{30}\right] - \$232 - \left[(\$10,000 - \$1,000) \times 2\% \times \frac{396}{365}\right] - \$6,500 = \$3,633$
- $\left[\$21,600 \times \frac{\$30,000}{(85\%)(\$85,000)}\right] - \left[(\$10,000 - \$1,000) \times 2\% \times \frac{365}{365}\right] - \$6,000 = \$2,789$

The least of the three figures is $2,789 and this will be the maximum 2019 deduction for Borris Industries.

***Part B***

In 2018, the Mercedes was used solely for personal purposes. In 2019, it was used primarily (more than 50 percent) for employment purposes, so he is eligible for the reduced standby charge and the alternative operating cost benefit calculation. However, since Mr. Borris' personal usage exceeds 20,004 kilometers during the year, the multiplier of the reduction formula is equal to 1 (20,004 ÷ 20,004). Given this, there is no reduction of the standby charge.

The taxable benefit that will be included in the Net Income For Tax Purposes of Mr. Borris for the two years (note the 2018 rate is different from 2019) is calculated as follows:

| | |
|---|---|
| Standby Charge - No Reduction [(2/3)(1)($1,800)] | $1,200 |
| Operating Cost Benefit - No Alternative [($0.26)(2,500)] | 650 |
| Repayment | ( 500) |
| 2018 Total Benefit | $1,350 |

| | |
|---|---|
| Standby Charge - No Reduction [(2/3)(12)($1,800)] | $14,400 |
| Operating Cost Benefit - Lesser Of: | |
| • [(1/2)($14,400) = $7,200 | |
| • [($0.28)(22,000)] | 6,160 |
| Repayment [($500)(12)] | ( 6,000) |
| 2019 Total Benefit | $14,560 |

## Self Study Solution Six - 6

***Analysis***

The choice between the two alternatives will be based on the comparative cash flows of the two alternatives. The relevant calculations are provided in the sections which follow.

***Employer Provides Automobile***

If Jerry elects to have the employer provide the Lexus, he will have a taxable benefit in each year. Since his employment related milage is greater than 50 percent, he is eligible for the reduced standby charge and the alternative operating cost benefit calculation. The after tax consequence of this choice would be as follows:

| | |
|---|---|
| Standby Charge (Reduced) | |
| [(2%)(12)($48,000)(15,000 ÷ 20,004)] | $8,638 |
| Operating Cost Benefit - Lesser Of: | |
| • [(1/2)($8,638)] = $4,319 | |
| • [($0.28)(15,000)] = $4,200 | 4,200 |
| Total Automobile Benefit | $12,838 |
| Marginal Tax Rate | 51% |
| Annual Increase In Tax | $ 6,547 |

### Jerry Buys the Automobile

The pre-tax cash inflows (outflows) associated with this alternative are as follows:

| | 2019 | 2020 | 2021 |
|---|---|---|---|
| Margin Loan Proceeds | $48,000 | N/A | N/A |
| Lexus Purchase | ( 48,000) | N/A | N/A |
| Allowance Received | 18,000 | $18,000 | $18,000 |
| Loan Repayment | ( 16,000) | ( 16,000) | ( 16,000) |
| Proceeds From Sale Of Car | N/A | N/A | 20,000 |
| Operating Costs [($0.24)(55,000)] | ( 13,200) | ( 13,200) | ( 13,200) |
| Financing Cost | | | |
| [(5%)($48,000)] | ( 2,400) | | |
| [(5%)($32,000)] | | ( 1,600) | |
| [(5%)($16,000)] | | | ( 800) |
| Pre-Tax Cash Inflows (Outflows) | ($13,600) | ($12,800) | $ 8,000 |

The tax savings (costs) associated with this alternative are as follows:

| | 2019 | 2020 | 2021 |
|---|---|---|---|
| Operating Costs [($0.28)(55,000)] | ($15,400) | ($15,400) | ($15,400) |
| Financing Costs (Less Than $10/Day) | ( 2,400) | ( 1,600) | ( 800) |
| CCA (See Note) | | | |
| [(150%)(30%)($30,000)] | ( 13,500) | | |
| [(30%)($30,000 - $13,500)] | | ( 4,950) | |
| [(1/2)(30%)($16,500 - $4,950)] | | | ( 1,733) |
| Total Automobile Costs | ($31,300) | ($21,950) | ($17,933) |
| Employment Usage (40,000 ÷ 55,000) | 72.7% | 72.7% | 72.7% |
| Deductible Amount | ($22,755) | ($15,958) | ($13,037) |
| Allowance | 18,000 | 18,000 | 18,000 |
| Inclusion In Taxable Income | ($ 4,755) | $ 2,042 | $ 4,963 |
| Marginal Tax Rate | 51% | 51% | 51% |
| Increase (Decrease) In Tax | ($ 2,425) | $ 1,041 | $ 2,531 |

**Note** As a Class 10.1 asset is involved, the CCA base is limited to $30,000 The AccII provisions are applicable. When the asset is sold, no recapture or terminal loss can be recognized on Class 10.1. However, one-half year CCA can be deducted in the year of disposal.

The net after tax cash outflow would be calculated as follows:

| | 2019 | 2020 | 2021 |
|---|---|---|---|
| Pre-Tax Cash Inflow (Outflow) | ($13,600) | ($12,800) | $8,000 |
| Tax Inflow (Outflow) | 2,425 | ( 1,041) | ( 2,531) |
| Net Cash Inflow (Outflow) | ($11,175) | ($13,841) | $5,469 |

### Best Alternative

A comparison of the two alternatives is as follows:

| Net Cash Inflows (Outflows) | 2019 | 2020 | 2021 | Total |
|---|---|---|---|---|
| Employer Provided | ($ 6,547) | ($ 6,547) | ($6,547) | ($19,641) |
| Employee Purchase | ( 11,175) | ( 13,841) | 5,469 | ( 19,547) |

There is less than $100 dollars difference in the outflows of the two alternatives with the employee purchase being slightly more advantageous. The cash flows of this alternative are enhanced by the AccII provisions in the year of acquisition.

### *Other Considerations*

There are a number of other considerations that could affect the choice of the best alternative, such as if the actual number of kilometers driven, or personal kilometers driven was to be different from the estimated, or if the resale value of the Lexus was not actually $20,000, but dealing with these factors is beyond the scope of this problem.

## Self Study Solution Six - 7

### *Market Determination - Two Possible Values*

For tax purposes, the business can measure market using either replacement cost or net realizable value. These values would be as follows:

| | |
|---|---|
| Replacement Cost [($16.75)(5,000)] | $83,750 |

| | |
|---|---|
| Net Realizable Value [($18.30)(5,000)] | $91,500 |

While it is not an acceptable practice under GAAP, the CRA will accept the use of market values, without regard to their relationship to cost.

### *Cost Determination - Two Possible Values*

In the determination of cost, taxpayers are permitted to use specific identification (this would not appear to be practical here), a First In, First Out (FIFO) assumption, or Average Cost.

Using the First In, First Out method, the appropriate value for the ending inventory would be determined as follows:

| | |
|---|---|
| 1,500 Units At $16.50 | $24,750 |
| 3,200 Units At $21.42 | 68,544 |
| 300 Units At $20.25 | 6,075 |
| 5,000 Units At FIFO Cost | $99,369 |

Based on average cost, the ending inventory value would be calculated as follows:

| | |
|---|---|
| Number Of Units | 5,000 |
| Average Cost [($297,644 ÷ 15,300)] | 19.45 |
| 5,000 Units At Average Cost | $97,250 |

### *Lower Of Cost And Market - Four Possible Values*

For tax purposes, the possible values here would be as follows:

| | |
|---|---|
| Lower Of Replacement Cost And FIFO Cost | $83,750 |
| Lower Of Replacement Cost And Average Cost | 83,750 |
| Lower Of Net Realizable Value And FIFO Cost | 91,500 |
| Lower Of Net Realizable Value And Average Cost | 91,500 |

For accounting purposes, only the last two values would be acceptable.

## Self Study Solution Six - 8

The appropriate treatment for each of the listed items would be as follows:

1. Neither current nor future income taxes can be deducted in the calculation of Net Income For Tax Purposes. As a consequence, $123,000 would be added back to Net Income to arrive at the required tax figure.

2. Interest on late tax instalments is not deductible in the calculation of Net Income For Tax Purposes. As a consequence, $400 would be added back to Net Income to arrive at the required tax figure.

3. In the calculation of Net Income For Tax Purposes, amortization expense of $83,000 must be added back to accounting Net Income and CCA of $97,000 must replace it as the appropriate deduction for tax purposes.

4. The club dues of $2,500 are not deductible for tax purposes and must be added back to Net Income in the calculation of Net Income For Tax Purposes. In addition, 50 percent of the cost of entertaining clients would not be deductible. This means that the non-deductible portion of the $9,600 total would be $4,800. This amount would also be added back to Net Income in the calculation of Net Income For Tax Purposes.

5. The appropriate tax deduction for bad debts is $6,000 ($5,200 - $3,400 + $4,200). As only $5,200 was deducted in the accounting records, $800 ($6,000 - $5,200) must be deducted in the calculation of Net Income For Tax Purposes.

6. As this life insurance policy was required in order to obtain financing, the premiums would be deductible. No adjustment is required in the calculation of Net Income For Tax Purposes.

7. Provided that they are paid within 180 days of year end, bonuses are deductible when declared by a business. This means that the full amount would be deductible and no adjustment is required in the calculation of Net Income For Tax Purposes.

8. The bond discount amortization is not deductible for tax purposes. As a consequence, the $3,200 must be added back to Net Income in the calculation of Net Income For Tax Purposes.

9. While the landscaping costs were given the appropriate capitalization treatment for accounting purposes, ITA 20(1)(aa) specifically permits such costs to be deducted in the year in which they are paid. Therefore, a deduction of $27,000 will be required in the conversion of accounting Net Income to Net Income For Tax Purposes.

## Self Study Solution Six - 9

The minimum net business income of Fairway Distribution would be calculated as follows:

| | |
|---|---|
| Accounting Income As Reported | $273,000 |
| Additions: | |
| Item 2 - Amortization | 78,500 |
| Item 3 - Cost Of Advertising In Foreign Newspaper (Note 1) | 3,500 |
| Item 3 - Donations To Charities (Note 2) | 1,260 |
| Item 3 - Cost Of Real Estate Appraisal (Note 3) | 1,470 |
| Item 3 - Cost Of Landscaping (Note 4) | 5,260 |
| Item 3 - Mrs. Fairway's Management Fee (Note 5) | 123,000 |
| Subtotal | $485,990 |
| Deductions: | |
| Item 1 - Bad Debt Expense Adjustment (Note 6) | ( 4,200) |
| Item 2 - CCA (Given) | ( 123,600) |
| Net Business Income | $358,190 |

**Note 1** In general, the cost of advertising in foreign media that is directed towards Canadian markets cannot be deducted for tax purposes. While there is an exception for foreign periodicals, it does not apply to foreign newspapers.

**Note 2** Donations to charities cannot be deducted in the calculation of net business income. They will be the basis for a tax credit in the calculation of Tax Payable for Mr. Fairway.

**Note 3** The cost of appraising a capital asset for purposes of sale is not deductible. Rather, it is an addition to the capital cost of the appraised asset.

**Note 4** While landscaping costs related to business properties are deductible when incurred, the cost of improving non-business personal use property would not be.

**Note 5** ITA 67 requires that business expenses be "reasonable in the circumstances". As Mrs. Fairway does not appear to do any work for the business, it would be difficult to view her management fee as reasonable. As a consequence, it would not be deductible.

**Note 6** For tax purposes, the bad debt adjustment would be calculated as follows:

| | |
|---|---|
| Last Year's Reserve | $15,000 |
| Actual Write-Offs | ( 17,500) |
| This Year's Reserve | ( 19,200) |
| Total Deduction For Tax Purposes | ($21,700) |
| Accounting Deduction (Actual Write-Offs) | 17,500 |
| Bad Debt Expense Adjustment | ($ 4,200) |

As $4,200 ($21,700 - $17,500) more than the amount that was written off for accounting purposes can be deducted for tax purposes, an adjustment is required. Note that the accounting procedures that were used in this case are not consistent with GAAP.

## Self Study Solution Six - 10

The Net Income For Tax Purposes of Darlington Inc. would be calculated as follows:

| | |
|---|---|
| Accounting Income | $ 596,000 |
| Additions: | |
| Item 1 - Income Tax Expense | 55,000 |
| Item 3 - Foreign Advertising (Note 1) | Nil |
| Item 4 - Amortization Expense | 623,000 |
| Item 4 - Taxable Capital Gain On Class 8 Disposition [($550,000 - $400,000)(1/2)] | 75,000 |
| Item 5 - Non-Deductible Meals And Entertainment [(50%)($41,400)] | 20,700 |
| Item 6 - Club Fees | 2,500 |
| Item 7 - Property Taxes On Vacant Land (Note 4) | 15,000 |
| Subtotal | $1,387,200 |
| Deductions: | |
| Item 2 - Landscaping Costs (Note 2) | ( 95,000) |
| Item 4 - Accounting Gain On Class 8 Disposition | ( 225,000) |
| Item 4 - CCA (Note 3) | ( 1,017,250) |
| Terminal Loss (See Class 10 CCA Calculation) | ( 113,000) |
| Net Income (Loss) For Tax Purposes | ($ 63,050) |

**Note 1** ITA 19.01 provides for the full deduction of advertising costs in foreign periodicals directed at the Canadian market, provided 80 percent or more of their non-advertising content is original editorial content. If the original editorial content is less than 80 percent, the deduction is equal to 50 percent of the costs. Note that this applies only to periodicals and not other print or broadcast media.

**Note 2** Landscaping costs are fully deductible.

**Note 3** The calculations for determining CCA are as follows:

**Class 1 - Buildings** The required calculations for this class would be as follows:

**Headquarters Building**

| | |
|---|---|
| January 1, 2019 UCC Balance | $1,000,000 |
| CCA At 4 Percent | ( 40,000) |
| January 1, 2020 UCC Balance | $ 960,000 |

**New Building (Separate Class)**

| | |
|---|---|
| Addition ($650,000 - $125,000) | $525,000 |
| AccII Adjustment [(50%)($525,000)] | 262,500 |
| CCA Base | $787,500 |
| CCA At 6 Percent | ( 47,250) |
| AccII Adjustment Reversal | ( 262,500) |
| January 1, 2020 UCC Balance | $477,750 |

**Class 8 - Office Furniture And Equipment** The required calculations for this class would be as follows:

| | | |
|---|---|---|
| January 1, 2019 UCC Balance | | $4,200,000 |
| Additions | $700,000 | |
| Dispositions - Lesser Of: | | |
| • Proceeds = $550,000 | | |
| • Cost = $400,000 | ( 400,000) | 300,000 |
| AccII Adjustment [(50%)($300,000)] | | 150,000 |
| CCA Base | | $4,650,000 |
| CCA At 20 Percent | | ( 930,000) |
| AccII Adjustment Reversal | | ( 150,000) |
| January 1, 2020 UCC Balance | | $3,570,000 |

With respect to the sale that occurred during the year, there would be a capital gain of $150,000 ($550,000 - $400,000). One-half, or $75,000, is included in the Company's Net Income For Tax Purposes, and the accounting gain of $225,000 is deducted.

**Class 10 - Vehicles** The calculations for this Class are as follows:

| | |
|---|---|
| January 1, 2019 UCC Balance | $800,000 |
| Disposition - Lesser Of: | |
| Capital Cost = $1,200,000 | |
| Proceeds Of Disposition = $687,000 | ( 687,000) |
| Ending Balance With No Remaining Assets In Class | $113,000 |
| Terminal Loss | ( 113,000) |
| January 1, 2020 UCC | Nil |

**Note 4** The property taxes on the vacant land are not deductible. They can be added to the cost of the land if the land was acquired for the purpose of earning either business or property income and may be deducted to the extent of any net income earned on the land.

### *Summary Of The Results (Not Required)*

The maximum 2019 CCA and January 1, 2020 UCC balances can be summarized as follows:

| Class | Maximum CCA | UCC |
|---|---|---|
| Class 1 - Main Class | $ 40,000 | $ 960,000 |
| Class 1 - Separate Class | 47,250 | 477,750 |
| Class 8 | 930,000 | 3,570,000 |
| Class 10 | Nil | Nil |
| Total | $1,017,250 | |

In addition, there was a taxable capital gain on the sale of the Class 8 assets of $75,000 and a terminal loss in Class 10 of $113,000.

## Self Study Solution Six - 11

### *Part I*

A. As covered in this Chapter 6, ITA 12(1)(l) requires inclusion of business income from a partnership. As explained in more detail in Chapter 18, Partnerships, each partner's share of partnership profits is considered personal income of each partner. The profit is calculated as though the partnership was an individual resident of Canada. Once determined, it is allocated as per the partnership agreement, with the allocated amount being included in the individual tax returns of each partner.

B. The basic rules of ITA 249.1(1) require that, in general, a partnership with members who are individuals use a December 31 fiscal year end. While ITA 249.1(4) allows a partnership to elect a fiscal year end other than December 31, this election requires complex adjustments for Additional Business Income that may or may not be worthwhile.

C. This question requires an analysis of whether the arrangement with the seamstresses is one of employment. This material is discussed in Chapter 3 which covers employment income. Detailed guidance can be found in the CRA Guide titled "Employee Or Self-Employed?" (RC4110).

The general approach to the employee vs. self-employed question is to determine the intent of the parties to the arrangement. While not conclusive, the first question that will be examined in making this determination is whether the business and the workers intended to have an employee/employer relationship or, alternatively, have the work done by the individuals as self-employed contractors. While there is not sufficient information to make this determination given the information in the problem, the partners should be advised that intent should be determined and supported by the appropriate actions (e.g., have the workers register for GST if they wish to treat them as self-employed contractors).

In the absence of information on intent, other factors can be considered as follows:

**Control** It appears that Montpetit does not exercise a large degree of control over the seamstresses. They are free to work when they choose and may provide their services to different payers at the same time. The seamstresses can choose to accept or refuse work from Montpetit.

**Ownership Of Tools And Equipment** The seamstresses provide the tools and equipment required for the work and the work is done in their homes, not in space provided by Montpetit.

**Ability To Subcontract Or Hire Assistants** It appears that Montpetit does not exercise control over who does the work as long as the quality is satisfactory.

**Financial Risk** Since the work is done for a set fee and the fabric and accessories are provided, there is no financial risk for seamstresses.

**Responsibility For Investment And Management** There is not enough information for this factor to be considered.

**Opportunity For Profit** Since the work is done for a set fee, a seamstress cannot increase her proceeds and hence the profit from a gown. Since the fabric and accessories are supplied and there would appear to be no other material expenditures needed for a gown, there is no opportunity to decrease expenses and increase profit on a gown. As a result, it does not appear that a profit could arise.

In addition to these factors, the work is for a specific gown, not general sewing as part of an ongoing relationship.

On balance, the seamstress contracts for the creation of designer gowns are likely contracts for service (self-employment contracts). Given this, source deductions

would not be required.

***Part II***

A. The $2,400 legal fees would be allocated to Class 14.1. The rate for this Class is 5 percent and it is subject to the half-year rule. For the current year, partnership could deduct CCA of $60 [(5%)(1/2)($2,400)].

B. The sewing machines are capital expenditures and cannot be deducted in the current year. However, a deduction will be available for CCA on these amounts. The sewing accessories can be deducted in the first year as they will be used and replaced in the same year.

C. While this point is not covered in the Business Income Chapter, because of its non-arm's length nature, interest paid to partners cannot be deducted in the determination of partnership income (see Chapter 18 on partnerships). Rather it will be treated as a drawing by the partners.

   The $10,000 contributions are of a capital nature and are not deductible in the calculation of personal Taxable Income.

D. The designer clothes held on consignment at year end are inventory of the partnership and are not deductible as cost of sales. The inventory will be valued either at lower of cost and market or, alternatively, market. The cost is given as $95,000 ($50,000 + $45,000) and the retail price is given as $260,000. It is likely that the net realizable value will be less than the full retail value, but the value cannot be determined with the information given.

E. The $15,000 payment for a limited term distribution right is a capital cost that cannot be currently deducted. However, it would be allocated to Class 14 (limited life intangibles) where it will be available for the deduction of CCA.

F. The payment of the annual membership is not deductible. The Crepe Suzette Diner expenses for entertainment of clients would be deductible, but they are subject to a 50 percent limitation, which means $750 [(50%)($1,500)] of these costs would be allowed as a business expense. The personal usage is not deductible.

## Self Study Solution Six - 12

Christine's minimum net business income can be calculated as follows:

**Design Power**
**Statement of Income and Expenses**
**For The Seven Month Period Ended December 31, 2019**

| | | |
|---|---|---|
| Revenues | | |
| Revenue collected | $22,000 | |
| Revenue billed | 4,000 | |
| Work-In-Progress (Note 1) | 1,500 | $27,500 |
| Expenses | | |
| Capital cost allowance (Note 2) | ($6,446) | |
| Work space in home expenses [(20%)($6,400)] | ( 1,280) | |
| Legal and business license fees | ( 1,000) | |
| Meals and entertainment [(50%)($500)] | ( 250) | |
| Automobile expenses (Note 3) | ( 1,960) | |
| Office and computer supplies | ( 650) | |
| Printing sub-contract fees | ( 1,800) | ( 13,386) |
| Net Business Income | | $14,114 |

**Note 1** ITA 34, which provided for the use of the billed basis of revenue recognition by some professionals, is being phased out. However, this is not relevant in this problem as a visual designers were never eligible for the use of this provision.

**Note 2** CCA amounts are calculated as follows:

| | Class 8 Furniture | Class 10 Car | Class 50 Computer |
|---|---|---|---|
| Additions | $2,000 | $18,000 | $5,000 |
| AccII Adjustment (50% Of Additions) | 1,000 | 9,000 | 2,500 |
| CCA Base | $3,000 | $27,000 | $7,500 |
| CCA Rate | 20% | 30% | 55% |
| CCA For Full Year | $ 600 | $ 8,100 | $4,125 |
| Non-Business Car Usage (30%) | N/A | ( 2,430) | N/A |
| Balance | $ 600 | $ 5,670 | $4,125 |
| Short Fiscal Period Factor | 214/365 | 214/365 | 214/365 |
| Deductible Amount | $ 352 | $ 3,324 | $2,418 |

Class 12 (Software) rate is 100%, but Class 12 is still under the (old) half-year rule. As a result, the CCA for Class 12 is:

**Class 12 CCA** = ($1,200)(1/2)(100%)(214/365) = $352

The non-business usage of the car is 30 percent. CCA is also restricted by the fact that Christine's taxation year only contains 214 days. Given these factors, the total maximum CCA is $6,446 ($352 + $3,324 + $2,418 + $352). Note that the CCA calculation is based on the portion of the year since the inception of the business, not the portion of the year since the assets were acquired.

**Note 3** As the interest amount is well below the prescribed limit, the amount is eligible for deduction, limited only by the amount of business usage. Also note that no portion of the down payment is deductible.

The deduction for automobile costs can be calculated as follows:

| | |
|---|---|
| Gasoline And Oil | 1,100 |
| Licence And Registration | 200 |
| Insurance | 800 |
| Interest On Car Loan | 700 |
| Potential Automobile Cost Deduction | $2,800 |
| Business Usage | 70% |
| Deductible Amount | $1,960 |

## Self Study Solution Six - 13

Carla's minimum net business income can be calculated as follows:

**Carla Jensen**
**Statement Of Business Income**
**For The Year Ending December 31, 2019**

| | | |
|---|---|---|
| Revenues | | |
| Billable Hours (Given) | $116,000 | |
| January 1, 2019 | | |
| Unbilled Work In Process (Note 1) | 23,200 | |
| December 31, 2019 | | |
| Unbilled Work In Process (Note 1) | ( 21,000) | $118,200 |
| Expenses | | |
| Building Operating Costs | ($24,500) | |
| Vehicle Operating Costs (Note 2) | ( 7,200) | |
| Payments To Assistants | ( 13,500) | |
| Miscellaneous Office Costs | ( 3,750) | |
| Business Meals [(50%)($4,200)] | ( 2,100) | |
| CCA (Note 3) | ( 36,633) | |
| Terminal Loss For Class 10 (Note 4) | ( 4,955) | ( 92,638) |
| Net Business Income | | $ 25,562 |

**Note 1** As Carla is a professional accountant she is eligible for the use of the billed basis of recognition. The problem requires the minimum business income so we can assume she makes the ITA 34 election to use the billed basis.

However, as noted in the text, beginning in 2018, this provision is being phased out over 5 years at the rate of 20 percent per year. This means that only $23,200 [(80 percent of $29,000)] of the ending 2018 balance could be deferred in that year. This amount will have to be brought back into Net Business Income in 2019.

For 2019, only $21,000 [(60%)($35,000)] of the ending 2019 balance can be deferred. The amount collected has no effect on the calculation of income under the accrual method.

**Note 2** The car leasing costs would be wholly deductible as the monthly lease charge and the manufacturer's list price are within the prescribed limits.

**Note 3** The total CCA deductible would be as follows (calculations shown separately):

| | |
|---|---|
| Class 1 | $13,560 |
| Class 8 | 17,700 |
| Class 12 | 363 |
| Class 14.1 | 3,525 |
| Class 50 | 1,485 |
| Total CCA | $36,633 |

**Class 1** As the building is used 100 percent for non-residential purposes, it is eligible for the enhanced rate of 6 percent. This means that the maximum CCA would be:

| | |
|---|---|
| Class 1 [($226,000)(6%)] | $13,560 |

**Class 8** The required calculations are as follows:

| | | |
|---|---|---|
| Opening Balance | | $46,500 |
| Additions | $34,000 | |
| Disposal - Lesser Of: | | |
| • Proceeds = $6,000 | | |
| • Cost = $18,000 | ( 6,000) | 28,000 |
| AccII Adjustment | | 14,000 |
| CCA Base | | $88,500 |
| Rate | | 20% |
| Class 8 CCA | | $17,700 |

**Class 12** The CCA on the applications software would be calculated as follows:

| | |
|---|---|
| Class 12 [(1/2)($725)(100%)] | $363 |

**Class 14.1** The CCA on the client list would be calculated as follows:

| | |
|---|---|
| Class 14.1 [(150%)($47,000)(5%)] | $3,525 |

**Class 50** The CCA on the new computer would be calculated as follows:

| | |
|---|---|
| Class 50 [(150%)($1,800)(55%)] | $1,485 |

**Note 4** As the only vehicle used by the business was disposed of during the year, there is no CCA for Class 10. However, as there is a balance left in the Class, there would be a terminal loss calculated as follows:

| | |
|---|---|
| UCC Of The Class At The Beginning Of The Year | $17,255 |
| Deduct: Dispositions During The Year - Lesser Of: | |
| • Capital Cost = $20,300 | |
| • Proceeds Of Disposition = $12,300 | ( 12,300) |
| Ending Balance With No Remaining Assets = Terminal Loss | $ 4,955 |

## Self Study Solution Six - 14

### *Part A - No Election*

If the ITA 22 election is not made, the tax consequences for Gail Gates would be as follows:

| | |
|---|---|
| Add: 2018 Reserve For Doubtful Debts | $15,000 |
| 2019 Income Inclusion | $15,000 |

While Gail has an allowable capital loss of $7,000 [(1/2)($263,000 - $249,000)], she will not be able to deduct this amount as she has had no capital gains in the previous three years and does not expect to have any in the current or subsequent years.

If the ITA 22 election is not made, the tax consequences to Mandy Portals would be as follows:

| | |
|---|---|
| Proceeds Of Disposition (Amount Collected) | $251,000 |
| Adjusted Cost Base | ( 249,000) |
| Capital Gain | $ 2,000 |
| Inclusion Rate | 1/2 |
| 2019 Income Inclusion | $ 1,000 |

### *Part A - Election*

If the ITA 22 election is made, the tax consequences for Gail would be as follows:

| | |
|---|---|
| Add: 2018 Reserve For Doubtful Debts | $15,000 |
| Deduct: Business Loss ($263,000 - $249,000) | ( 14,000) |
| 2019 Income Inclusion | $ 1,000 |

If the ITA 22 election is made, the tax consequences to Mandy would be as follows:

| | |
|---|---|
| Add: Face Value - Price Paid ($263,000 - $249,000) | $14,000 |
| Deduct: Actual Write-Offs ($263,000 - $251,000) | ( 12,000) |
| 2019 Income Inclusion | $ 2,000 |

### *Part B*

For Gail Gates, the ITA 22 election is clearly desirable, converting a $15,000 income inclusion into a $1,000 inclusion.

For Mandy Portals, the fact that actual collections ($251,000) exceed the estimated value of the Accounts Receivable on the date of the sale ($249,000), means that the ITA 22 election would not be desirable. It would double her income inclusion from $1,000 to $2,000.

## Self Study Solution Six - 15

### *Net Employment Income*

The required calculations here are as follows:

| | |
|---|---|
| Salary | $123,000 |
| Additions | |
| Commissions | 11,500 |
| Car Allowance [($800)(12)] | 9,600 |
| Stock Option Benefit [($28 - $23)(500)] | 2,500 |
| Deductions | |
| RPP Contributions | ( 6,300) |
| Car Operating Costs [($9,300)(31,000 ÷ 46,000)] | ( 6,267) |
| Car CCA [($30,000)(30%)(150%)(31,000 ÷ 46,000)] | ( 9,098) |
| Travel [($8,500 + $4,500 + (1/2)($2,000)] | ( 14,000) |
| Client Meals And Entertainment (See Notes) | Nil |
| Parking | Nil |
| Net Employment Income | $110,935 |

**Notes:**

- The fact the initial option price is below market value does not change the calculation of the employment income inclusion. However, there will be no deduction under ITA 110(1)(d) in the determination of Taxable Income.
- The car allowance must be included in income as it is not based on kilometers of use.
- The base for the CCA on the car is limited to $30,000.
- Travel and client promotion costs of $18,300 [($8,500 + $4,500 + (1/2)($2,000 + $8,600)] could be deducted under ITA 8(1)(f). However, this deduction is limited to his commission income of $11,500. He is better off deducting the travel costs of $14,000 [$8,500 + $4,500 + (1/2)($2,000)] using ITA 8(1)(h). As discussed in the text, he cannot use both of the provisions in the same year.

### Net Business Income

The required calculations for net business income are as follows:

| | |
|---|---|
| Net Business Income Before CCA (Given) | $189,000 |
| Class 1 CCA [(4%)($472,200)] | ( 18,888) |
| Class 8 CCA [(20%)($143,300)] | ( 28,660) |
| Class 50 CCA [(55%)($12,500)] | ( 6,875) |
| Net Business Income | $134,577 |

### Net Income For Tax Purposes And Taxable Income

Since there is no stock option benefit deduction, the required calculation here is as follows:

| | |
|---|---|
| Net Employment Income | $110,935 |
| Net Business Income | 134,577 |
| Net Income For Tax Purposes And Taxable Income | $245,512 |

### Tax Payable

The required calculations are as follows:

| | | |
|---|---|---|
| Tax On First $210,371 | | $48,719 |
| Tax On Next $35,141 ($245,512 - $210,371) At 33 Percent | | 11,597 |
| Tax Before Credits | | $60,316 |
| Tax Credits: | | |
| Basic Personal Amount (Andrew) | ($12,069) | |
| Common-Law Partner Including Infirm Amount ($12,069 + $2,230 - $4,500) | ( 9,799) | |
| Canada Caregiver - Bart | ( 7,140) | |
| Transfer Of John's Disability Credit | ( 8,416) | |
| EI Premiums | ( 860) | |
| CPP Contributions | ( 2,749) | |
| Canada Employment | ( 1,222) | |
| Transfer Of Tuition - Lesser Of: | | |
| • Absolute Limit Of $5,000 | | |
| • Actual Tuition Of $17,000 | ( 5,000) | |
| Medical Expenses (Note) | ( 17,464) | |
| Total Credit Base | ($64,719) | |
| Rate | 15% | ( 9,708) |
| Federal Tax Payable | | $50,608 |

**Note** The medical expense credit base would be calculated as follows:

| | | |
|---|---|---|
| Medical Expenses For Andrew, John, And Carl ($2,300 + $12,600 + $400) | | $ 15,300 |
| Reduced By The Lesser Of: | | |
| • [(3%)($245,512)] = $7,365 | | |
| • 2019 Threshold Amount = $2,352 | | ( 2,352) |
| Balance Before Dependants 18 And Over | | $ 12,948 |
| Bart's Medical Expenses | $4,600 | |
| Reduced By The Lesser Of: | | |
| • $2,352 | | |
| • [(3%)($2,800)] = $84 | ( 84) | 4,516 |
| Total Medical Expense Claim | | $17,464 |

## Self Study Solution Six - 16

### *Net Employment Income*

The Net Employment Income component of Net Income For Tax Purposes would be calculated as follows:

| | |
|---|---|
| Salary | $ 89,000 |
| Additions | |
| Commissions | 12,000 |
| Automobile Benefit (Note 1) | 1,140 |
| Travel Allowance (Note 2) | Nil |
| Art Course Tuition Benefit (Note 3) | 600 |
| Near Cash Gift (Note 4) | 400 |
| Stock Option Benefit [(1,500)($61 - $52)] | 13,500 |
| Deductions | |
| RPP Contributions | ( 3,750) |
| Union Dues | ( 430) |
| Net Employment Income | $112,460 |

**Note 1** The automobile benefit would be calculated as follows:

| | |
|---|---|
| Standby Charge [(2/3)($459)(11)(8,500 ÷ 18,337)] | $1,560 |
| Operating Cost Benefit - Lesser Of: | |
| • [($0.28)(8,500)] = $2,380 | |
| • ($1,560 ÷ 2) = $780 | 780 |
| Total Benefit Before Repayment | $2,340 |
| Repayment | ( 1,200) |
| Automobile Benefit | $1,140 |

**Note 2** As the travel allowance appears to be reasonable given his actual costs, it does not have to be included in Mr. Bowles' income and it is more advantageous for him not to do so. Correspondingly, he cannot deduct the travel costs incurred.

**Note 3** Tuition for the marketing course would appear to be employment related and, as a consequence, would not be included in Mr. Bowles' employment income.

**Note 4** While the non-cash gift for years of service does not have to be included in income, the $400 gift certificate, i.e. near cash gift, must be included.

### *Net Business Income*

The Net Business Income component of Net Income For Tax Purposes would be calculated as follows:

| | | |
|---|---|---|
| Amounts Billed | | $50,250 |
| Deductions: | | |
| Office Rent (12 Months At $500) | ($6,000) | |
| CCA (Note 5) | ( 7,967) | |
| Part Time Assistant | ( 5,725) | |
| Office Supplies | ( 347) | |
| Monthly Telephone Service | ( 312) | |
| Cell Phone Charges | ( 211) | |
| Meals And Entertainment [(1/2)($3,150)] | ( 1,575) | ( 22,137) |
| Net Business Income | | $28,113 |

**Note 5** Maximum CCA would be calculated as follows:

| | |
|---|---|
| Class 13 [(150%)($12,000 ÷ 5*)] | $3,600 |
| Class 8 [(150%)(20%)($10,000)] | 3,000 |
| Class 50 [(150%)(55%)($1,150)] | 949 |
| Class 12 [(1/2)(100%)($836)] (No AccII Adjustment) | 418 |
| Total | $7,967 |

*With respect to the Class 13 amount, this is a straight line Class and it is subject to the half year rules. While the term of the lease is only three years, the deductible amount is the lesser of the capital cost divided by the term of the lease and one-fifth of the capital cost. In this case, the deduction is limited to one-half of one-fifth of the capital cost.

### *Net Income For Tax Purposes And Taxable Income*

Mr. Bowles has Net Income For Tax Purposes and Taxable Income as follows:

| | |
|---|---|
| Net Employment Income | $112,460 |
| Net Business Income | 28,113 |
| Net Income For Tax Purposes | $140,573 |
| Stock Option Deduction [($13,500)(1/2)] | ( 6,750) |
| Taxable Income | $133,823 |

### *Federal Tax Payable*

The required calculations are as follows:

| | | |
|---|---|---|
| Tax On First $95,259 | | $16,908 |
| Tax On Next $38,564 ($133,823 - $95,259) At 26 Percent | | 10,027 |
| Tax Before Credits | | $26,935 |
| Tax Credits: | | |
| Basic Personal Amount | ($12,069) | |
| Spouse ($12,069 - $3,450) | ( 8,619) | |
| EI Premiums | ( 860) | |
| CPP Contributions | ( 2,749) | |
| Canada Employment | ( 1,222) | |
| Tuition Credit - Mr. Bowles (Note 6) | ( 600) | |
| Transfer Of Tuition - Lesser Of: | | |
| • $5,000 | | |
| • $9,800 | ( 5,000) | |
| Medical Expenses (Note 7) | ( 10,138) | |
| Total Credit Base | ($41,257) | |
| Rate | 15% | ( 6,189) |
| Charitable Donations | | |
| [(15%)($200) + (29%)($1,425 - $200)] | | ( 385) |
| Political Contributions [(3/4)($275)] | | ( 206) |
| Federal Tax Payable Before Refundable Credits | | $20,155 |

**Note 6** As Mr. Bowles included the reimbursement of the art course in his employment income as a taxable benefit, he can claim the tuition fee credit.

**Note 7** The amount of medical expenses that can be included is calculated as follows:

| | | |
|---|---|---|
| Medical Expenses For Martin, Sally, And Marie ($2,500 + $1,850 + $1,600) | | $ 5,950 |
| Lesser Of: | | |
| • [(3%)($133,823)] = $4,015 | | |
| • 2019 Threshold Amount = $2,352 | | ( 2,352) |
| Balance Before Dependants 18 And Over | | $ 3,598 |
| Ellen's Medical Expenses | $6,540 | |
| Reduced By The Lesser Of: | | |
| • $2,352 | | |
| • [(3%)(Nil)] = Nil | Nil | 6,540 |
| Total Medical Expense Claim | | $10,138 |

## Chapter 6 Learning Objectives

After completing Chapter 6, you should be able to:

1. Classify property based on its use and determine what type of income will be produced while the asset is being held and when it is disposed of (paragraph [P hereafter] 6-1 to 6-16).
2. Describe the tax factors that can be affected by the classification of income as business or property (P 6-17 to 6-27).
3. Distinguish between business income and capital gains, including the criteria used by the courts in making this distinction (P 6-28 to 6-42).
4. Describe the major differences between net business income and Net Income as determined under GAAP (P 6-43 to 6-45).
5. Recall the various items that are included in net business income (P 6-46 to 6-53 and P 6-64 to 6-65).

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6. Apply the system of reserves that can be used in determining net business income (P 6-54 to 6-63).
7. Apply the limitations on deductions that apply to business and property income, including those on home office costs (P 6-66 to 6-103).
8. Apply the limitations on deductions that apply to business, property and employment income, including those related to meals and entertainment and automobile costs (P 6-104 to 6-132).
9. Apply the inventory valuation procedures that are used for determining net business income (P 6-133 to 6-141).
10. Recall the deductions that are specified in the *Income Tax Act* for calculating net business income (P 6-142 to 6-143).

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11. Reconcile accounting Net Income with net business income (P 6-144 to 6-149).
12. Recall the rules for determining taxation years and calculate additional business income for non-calendar fiscal years (P 6-150 to 6-157).
13. Apply the special provisions related to farm activities and farm losses (P 6-158 to 6-169).
14. Apply the special rule for unbilled work in process applicable to the income of some professionals (P 6-170 to 6-174).
15. Apply the provisions related to the disposition of inventories and accounts receivable in situations where a business is being sold (P 6-175 to 6-181).

# CHAPTER 7

## How To Work Through Chapter 7

We recommend the following approach in dealing with the material in this chapter:

**Property Income - General Concept**

- Read paragraph 7-1 to 7-5 (in the textbook).

**Interest As A Deduction, Including IT Folio S3-F6-C1**

- Read paragraph 7-6 to 7-28.
- Do Self Study Problem Seven-1 which is available on MyLab and check the solution in this Study Guide.

**Discount And Premium On Long-Term Issued Debt**

- Read paragraph 7-29 to 7-35.
- Do Exercise Seven-1 (in the textbook) and check the solution in this Study Guide.
- Read paragraph 7-36 to 7-37.
- Do Exercise Seven-2 and check the solution in this Study Guide.

**Interest Income - General Provisions**

- Read paragraph 7-38 to 7-45.
- Do Exercise Seven-3 and check the solution in this Study Guide.

**Discount And Premium On Long-Term Debt Holdings**

- Read paragraph 7-46 to 7-47.

**Accrued Interest At Transfer**

- Read paragraph 7-48 to 7-50.
- Do Exercise Seven-4 and check the solution in this Study Guide.

**Payments Based On Production Or Use (Royalties)**

- Read paragraph 7-51 to 7-53.

**Rental Income**

- Read paragraph 7-54 to 7-65.
- Do Exercise Seven-5 and check the solution in this Study Guide.
- Do Self Study Problem Seven-2 and check the solution in this Study Guide.

**Eligible And Non-Eligible Cash Dividends Received**

- Read paragraph 7-66 to 7-85.
- Do Exercise Seven-6 and check the solution in this Study Guide.
- Read paragraph 7-86 to 7-95.
- Do Exercise Seven-7 and check the solution in this Study Guide.

### Comparison Of Investment Returns

- Read paragraph 7-96 to 7-97.
- Do Self Study Problems Seven-3 to Seven-6 and check the solutions in this Study Guide.

### Income Trusts

- Read paragraph 7-98 to 7-111.
- Do Exercise Seven-8 and check the solution in this Study Guide.

### Mutual Funds

- Read paragraph 7-112 to 7-122.
- Do Exercise Seven-9 and check the solution in this Study Guide.
- Do Self Study Problem Seven-7 and check the solution in this Study Guide.

### Stock Dividends And Capital Dividends

- Read paragraph 7-123 to 7-128.
- Do Exercise Seven-10 and check the solution in this Study Guide.

### Foreign Source Income

- Read paragraph 7-129 to 7-132.
- Do Exercise Seven-11 and check the solution in this Study Guide.

### Shareholder Benefits

- Read paragraph 7-133 to 7-135.

### Tax Credits Revisited - Dividend And Foreign Tax Credits

- Read paragraph 7-136 to 7-139.
- Do Self Study Problems Seven-8 and Seven- 9 and check the solutions in this Study Guide.

### To Complete This Chapter

- If you would like more practice in problem solving, do the Supplementary Self Study Problems for the chapter. These problems and solutions are available on MyLab.
- Review the Key Terms Used In This Chapter in the textbook at the end of Chapter 7. Consult the Glossary for the meaning of any key terms you do not know.
- Test yourself with the Chapter 7 Glossary Flashcards available on MyLab.
- Ensure you have achieved the Chapter 7 Learning Objectives listed in this Study Guide.
- As a review, we recommend you view the PowerPoint presentation for Chapter 7 that is on MyLab.

### Practice Examination

- Write the Practice Examination for Chapter 7 that is on MyLab. Mark your examination using the Practice Examination Solution that is also on MyLab.

## Solutions to Chapter Seven Exercises

### *Exercise Seven - 1 Solution*

**Tax Consequences** The tax consequences would be as follows:

| | |
|---|---|
| Annual Deduction - 2019 Through 2021 [($1,000,000)(4%)] | $40,000 |

| | |
|---|---|
| Maturity Amount | $1,000,000 |
| Proceeds Of Sale | ( 985,000) |
| 2021 Loss | $ 15,000 |

The bonds are sold for more than 97 percent of their maturity amount. In addition, the four-thirds test is met since the effective interest rate of 4.6 percent is less than four-thirds of the coupon rate [(4%)(4/3) = 5.3%]. As a result, this loss would be fully deductible. This gives a total deduction of $135,000 over the 3 year period [(3)($40,000) + $15,000].

**Accounting Consequences** The accounting consequences would be as follows:

| | |
|---|---|
| Annual Interest Payment [($1,000,000)(4%)] | $40,000 |
| Discount Amortization [($1,000,000 - $985,000) ÷ 3] | 5,000 |
| Annual Interest Expense - 2019 Through 2021 | $45,000 |

Payment of the maturity amount in 2021 would have no tax consequences. Note that the total for the 3 year period would be the same $135,000 [(3)($45,000)] that was deducted for tax purposes.

### *Exercise Seven - 2 Solution*

The tax consequences under each of the three assumptions would be as follows:

**Money Lender** In this case, there would be an income inclusion of $400,000 ($1,400,000 - $1,000,000) in the current year. The interest deduction for the year would be $180,000 [(18%)($1,000,000)].

**No Deliberate Premium** In this case, the premium would have no immediate tax consequences and there would be no tax consequences when the bonds mature. The interest deduction for the year would be $180,000 [(18%)($1,000,000)]. Given that the bonds are paid off for less than the proceeds from their issuance, this result provides the issuer of the bonds with a tax free capital receipt of $400,000.

**Deliberate Premium** In this case, the premium would be amortized at the rate of $40,000 per year ($400,000 ÷ 10). This means the interest deduction for the year would be $140,000 ($180,000 - $40,000).

### *Exercise Seven - 3 Solution*

The total interest to be recorded on the instrument is $28,800 [($60,000)(8%)(6 years)]. It will be allocated as follows:

| Year | Interest Paid | Interest Reported |
|---|---:|---:|
| 2019 | Nil | Nil |
| 2020 | Nil | $ 4,800 |
| 2021 | Nil | 4,800 |
| 2022 | $15,600 | 6,000 |
| 2023 | Nil | 3,600 |
| 2024 | Nil | 4,800 |
| 2025 | 13,200 | 4,800 |
| Total | $28,800 | $28,800 |

**2019** As no anniversary date occurred and no interest was received during 2019, no interest will have to be included in Ms. Dumont's 2019 tax return.

**2020** The first anniversary date occurs on September 30 and this requires the recognition of $4,800 [(8%)($60,000)] of interest.

**2021** The second anniversary date occurs and this requires the recognition of an additional $4,800 of interest.

**2022** An additional $4,800 will have to be recognized because of the third anniversary date. Also during this year, a payment of $15,600 [($4,800)(3.25)] is received. Of this total, $14,400 [(3)($4,800)] has been recognized because of the three anniversary dates. This will require the recognition of an additional $1,200 ($15,600 - $14,400) in 2021, bringing the total for the year to $6,000 ($4,800 + $1,200).

**2023** The anniversary date will require recognition of $4,800. However, only $3,600 of this amount will be included as $1,200 was received and recognized in 2021.

**2024** $4,800 will be recognized on the anniversary date.

**2025** A payment of $13,200 [(2.75)($4,800)] will be received. As $8,400 ($3,600 + $4,800) of the amount received has been recorded on the two anniversary dates, the total for 2025 will be $4,800 ($13,200 - $8,400).

### *Exercise Seven - 4 Solution*

Mr. Lay will include the full $6,000 received in income. However, he can deduct the interest that was accrued on the bonds at the time of purchase of $1,989 [($3,000)(120/181)]. The net amount that will be included in his tax return is $4,011 ($6,000 - $1,989).

### *Exercise Seven - 5 Solution*

The maximum CCA for Class 1 would be calculated as follows:

| | |
|---|---:|
| Capital Cost ($185,000 - $42,000) | $143,000 |
| Improvements | 35,000 |
| Total Additions | $178,000 |
| Accelerated Investment Incentive (AccII) Multiplier | 150% |
| Adjusted CCA Base | $267,000 |
| Rate | 4% |
| Maximum CCA | $ 10,680 |

The required rental income calculation would be as follows:

| | |
|---|---|
| Rental Revenues | $7,200 |
| Rental Expenses Other Than CCA | ( 5,100) |
| Rental Income Before CCA | $2,100 |
| CCA (Maximum) | ( 2,100) |
| Net Rental Income | Nil |

As CCA cannot be used to create a net rental loss, the actual deduction is limited to $2,100, the rental income before CCA. Also note that the maximum available CCA is not limited by the fact the property was purchased in September as the calendar year is considered the fiscal year for property income purposes for individuals.

### Exercise Seven - 6 Solution

The Tax Payable by Ms. Holt would be calculated as follows:

| | |
|---|---|
| Eligible Dividends Received | $15,000 |
| Gross Up At 38 Percent | 5,700 |
| Taxable Dividends | $20,700 |
| Combined Federal/Provincial Tax Rate (29% + 14.5%) | 43.5% |
| Tax Before Dividend Tax Credit | $ 9,005 |
| Dividend Tax Credit [(6/11 + 30%)($5,700)] | ( 4,819) |
| Federal And Provincial Tax Payable | $ 4,186 |

The after tax retention is $10,814 ($15,000 - $4,186). Note that to calculate this amount, the taxes are deducted from the dividends received and not the grossed up taxable dividends.

### Exercise Seven - 7 Solution

The Tax Payable by Mr. Johns would be calculated as follows:

| | |
|---|---|
| Non-Eligible Dividends Received | $17,000 |
| Gross Up At 15 Percent | 2,550 |
| Taxable Dividends | $19,550 |
| Combined Federal/Provincial Tax Rate (29% + 12%) | 41% |
| Tax Before Dividend Tax Credit | $ 8,016 |
| Dividend Tax Credit [(9/13 + 30%)($2,550)] | ( 2,530) |
| Federal And Provincial Tax Payable | $ 5,486 |

The after tax retention is $11,514 ($17,000 - $5,486). Note that to calculate this amount, the taxes are deducted from the dividends received and not the grossed up taxable dividends.

### Exercise Seven - 8 Solution

John will include an additional $7,000 [(2,000)($5.00 - $1.50)] in his Net Income For Tax Purposes. His adjusted cost base will be increased by the $10,000 [(2,000)($5.00)] reinvestment of the distribution and reduced by the $3,000 [(2,000)($1.50)] return of capital.

The reinvestment of the $10,000 distribution will result in the acquisition of an additional 175.44 ($10,000 ÷ $57) units. The adjusted cost base calculations are as follows:

| | Amount | Number Of Units |
|---|---|---|
| Original Investment | $110,000 | 2,000.00 |
| Reinvestment Of Distribution | 10,000 | 175.44 |
| Tax Free Return Of Capital | ( 3,000) | N/A |
| Adjusted Cost Base/Number Of Units | $117,000 | 2,175.44 |

This will result in an average cost of $53.78 ($117,000 ÷ 2,175.44) per unit.

### Exercise Seven - 9 Solution

Given the purchase price per unit is $13, the reinvestment will result in Ms. Tiompkins receiving 80.77 ($1,050 ÷ $13) additional units. This will leave her holding 3,580.77 units with an adjusted cost base of $40,425 ($39,375 + $1,050). Her adjusted cost base per unit after the reinvestment is $11.29 ($40,425 ÷ 3,580.77).

### Exercise Seven - 10 Solution

The required calculations would be as follows:

| | |
|---|---|
| Original Shares Held | 200,000 |
| Stock Dividend Percentage | 10% |
| New Shares Acquired | 20,000 |
| Per Share Addition To Paid Up Capital | $15 |
| Eligible Stock Dividend Received | $300,000 |
| Gross Up At 38 Percent | 114,000 |
| Taxable Eligible Dividend | $414,000 |

There would be a federal dividend tax credit of $62,182 [(6/11)($114,000)]. The $300,000 stock dividend would be added to the $2,400,000 [($12)(10%)(2,000,000)] original cost of his shares and the adjusted cost base per share would be calculated as follows:

[($2,400,000 + $300,000) ÷ (200,000 + 20,000)] = $12.27

Note that his percentage of ownership remains at 10 percent (220,000 ÷ 2,200,000).

### Exercise Seven - 11 Solution

The federal Tax Payable on the amount received assuming it is foreign non-business income or business income would be calculated as follows:

| | Non-Business Income | Business Income |
|---|---|---|
| Amount Received | $22,500 | $22,500 |
| Foreign Tax Withheld | 7,500 | 7,500 |
| Inclusion For Foreign Income | $30,000 | $30,000 |
| Deduction Of Excess Withholding [$7,500 - (15%)($30,000)] | ( 3,000) | N/A |
| Increase In Taxable Income | $27,000 | $30,000 |
| Rate | 29% | 29% |
| Tax Payable Before Credit | $ 7,830 | $ 8,700 |
| Foreign Tax Credit [(15%)($30,000)] | ( 4,500) | |
| Foreign Tax Credit (Amount Withheld) | | ( 7,500) |
| Federal Tax Payable | $ 3,330 | $ 1,200 |

Note that the total tax cost if the foreign income is business income is $8,700 ($7,500 + $1,200). This is the same amount that would have been paid by Norah on the receipt of $30,000 of Canadian source business income [(29%)($30,000) = $8,700]. This compares to a tax cost of $10,830 ($7,500 + $3,330) in the non-business income case. This reflects the fact that the $3,000 deduction of the excess foreign tax withholding is not as valuable as the $3,000 credit against Tax Payable that was received in the business income case.

## Self Study Solution Seven - 1

### *Case A*

The interest would be deductible as the direct use of the borrowed funds was to acquire the Bee Ltd. shares.

### *Case B*

Since the proceeds exceed the borrowings, Ms. Burns has complete flexibility with respect to linking. She could allocate all of the $225,000 to property B or alternatively, $50,000 to property A, with the other $175,000 going to property B. Any other allocation totaling $225,000 would be acceptable.

### *Case C*

When the value of the replacement property is less than the amount borrowed, the taxpayer must use a pro-rata allocation of the borrowed money. In this case, the result would be an allocation of $71,053 [($60,000 ÷ $190,000)($225,000)] to property A and an allocation of $153,947 [($130,000 ÷ $190,000)($225,000)] to property B.

### *Case D*

Under ITA 20.1 (the disappearing source rules), the $145,000 balance will be deemed to be used to produce income. Therefore, he can continue to deduct the interest.

## Self Study Solution Seven - 2

### *2018 (Pre-AccII)*

The maximum CCA for 2018 would be calculated as follows:

| | Class 1 | Class 8 |
|---|---|---|
| Addition | $690,000 | $43,000 |
| One-Half Net Additions | ( 345,000) | ( 21,500) |
| CCA Base | $345,000 | $21,500 |
| Maximum CCA: | | |
| [(4%)($345,000)] | ( 13,800) | |
| [(20%)($21,500)] | | ( 4,300) |
| Add: One-Half Net Additions | 345,000 | 21,500 |
| January 1, 2019 UCC | $676,200 | $38,700 |

Net Rental Income for 2018 would be calculated as follows:

| | |
|---|---|
| Rental Revenue | $63,600 |
| Expenses Other Than CCA | ( 23,400) |
| Income Before CCA | $40,200 |
| Class 1 CCA | ( 13,800) |
| Class 8 CCA | ( 4,300) |
| Net Rental Income | $22,100 |

Note that when an individual uses assets to produce property income (e.g., rental income), the full calendar year is considered to be the taxation year of the individual. This means that the short fiscal period rules are not applicable to Mr. Thorne.

***2019***

The results of the Class 8 disposition would be calculated as follows:

| | |
|---|---|
| January 1, 2019 UCC | $38,700 |
| Disposition - Lesser Of: | |
| • Cost = $43,000 | |
| • Proceeds Of Disposition = $31,000 | ( 31,000) |
| Positive Balance With No Remaining Assets In Class | $ 7,700 |
| Terminal Loss | ( 7,700) |
| January 1, 2020 UCC - Class 8 | Nil |

The terminal loss will be deducted from the Class 8 UCC leaving a January 1, 2020 balance of nil.

The maximum CCA for 2019 would be 27,048 [(4%)($676,200)]. However, as the deduction of CCA cannot be used to create a loss, the actual amount deducted would be limited to $17,400, as shown in the calculation of Net Rental Income.

| | |
|---|---|
| Rental Revenue | $54,500 |
| Expenses Other Than CCA And Terminal Loss | ( 29,400) |
| Terminal Loss On Class 8 Assets | ( 7,700) |
| Income Before CCA | $17,400 |
| CCA (Limited To Income Before CCA) | ( 17,400) |
| Net Rental Income | Nil |

The January 1, 2020 UCC of the Class 1 building would be calculated as follows:

| | |
|---|---|
| January 1, 2019 UCC | $676,200 |
| 2019 CCA Deducted | ( 17,400) |
| January 1, 2020 UCC - Class 1 | $658,800 |

## Self Study Solution Seven - 3

### *Part A - Bonds (Interest)*

The after tax returns on the bonds would be calculated as follows:

| | Sarah | Sally | Suzanne |
|---|---|---|---|
| Interest [(4.5%)($15,000)] | $675 | $675 | $675 |
| Federal/Provincial Tax Payable | | | |
| Sarah (15% + 5% = 20%) | ( 135) | | |
| Sally (26% + 11% = 37%) | | ( 250) | |
| Suzanne (33% + 16% = 49%) | | | ( 331) |
| After Tax Return - Interest | $540 | $425 | $ 344 |

### *Part B - Preferred Stock (Dividends)*

The after tax returns resulting from an investment in the preferred stock begins with the calculation of the federal and provincial Tax Payable:

| | Sarah (20%) | Sally (37%) | Suzanne (49%) |
|---|---|---|---|
| Dividends [(5.6%)($15,000)] | $ 840 | $ 840 | $ 840 |
| Gross Up Of 38 Percent | 319 | 319 | 319 |
| Taxable Dividend | $1,159 | $1,159 | $1,159 |
| Combined Rate (See Part A) | 20% | 37% | 49% |
| Tax Before Dividend Tax Credit | $ 232 | $ 429 | $ 568 |
| Dividend Tax Credit | | | |
| [(6/11 + 27%)($319)] | ( 260) | ( 260) | ( 260) |
| Tax Payable (Tax Savings) | ($ 28) | $ 169 | $ 308 |

Based on the preceding calculations of federal and provincial Tax Payable, the after tax returns on the preferred shares are calculated as follows:

| | Sarah (20%) | Sally (37%) | Suzanne (49%) |
|---|---|---|---|
| Dividends [(5.6%)($15,000)] | $840 | $840 | $840 |
| Tax Savings (Tax Payable) | 28 | ( 169) | ( 308) |
| After Tax Return - Dividends | $868 | $671 | $532 |

### *Comparison*

A comparison of the after tax rates of return can be made as follows:

| | Sarah (20%) | Sally (37%) | Suzanne (49%) |
|---|---|---|---|
| After Tax Dividends | $868 | $671 | $532 |
| After Tax Interest | ( 540) | ( 425) | ( 344) |
| Advantage Of Preferred Stock | $328 | $246 | $188 |

### *Recommendation*

For each of the sisters, the preferred stock offers the superior after tax return. Note, however, that the advantage of the dividends declines as the taxpayer's tax rate increases. In addition, there is a somewhat higher level of risk associated with preferred shares.

## Self Study Solution Seven - 4

In the following solution, note that the after tax return amount does not include the original investment. Some students add $600,000 to the after tax return which is not correct.

### *Guaranteed Investment Certificate*

The required calculations for this investment are as follows:

| | |
|---|---|
| Interest Received [($600,000)(4.5%)] | $27,000 |
| Combined Federal/Provincial Tax Rate (29% + 12%) | 41% |
| Tax Payable | $11,070 |

| | |
|---|---|
| Interest Received | $27,000 |
| Tax Payable | ( 11,070) |
| After Tax Return - Guaranteed Investment Certificate | $15,930 |

### *Preferred Shares*

The required calculations for this investment are as follows:

| | |
|---|---|
| Dividends Received [($600,000)(5.25%)] | $31,500 |
| Gross Up of 38 Percent | 11,970 |
| Taxable Income | $43,470 |
| Combined Federal/Provincial Tax Rate (29% + 12%) | 41% |
| Tax Payable Before Dividend Tax Credit | $17,823 |
| Federal/Provincial Dividend Tax Credit [($11,970)(6/11 + 28%)] | ( 9,881) |
| Total Tax Payable | $ 7,942 |

| | |
|---|---|
| Dividends Received (Before Gross Up) | $31,500 |
| Tax Payable | ( 7,942) |
| After Tax Return - Preferred Shares | $23,558 |

### *High Tech Shares*

The required calculations for this investment are as follows:

| | |
|---|---|
| Proceeds Of Disposition | $675,000 |
| Adjusted Cost Base | ( 600,000) |
| Capital Gain | $ 75,000 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain | $37,500 |
| Combined Federal/Provincial Tax Rate (29% + 12%) | 41% |
| Tax Payable | $15,375 |

| | |
|---|---|
| Capital Gain Realized (100%) | $75,000 |
| Tax Payable | ( 15,375) |
| After Tax Return - High Tech Shares | $59,625 |

## Self Study Solution Seven - 5

The major considerations in deciding between the three alternative investment strategies are the after tax return and the certainty of the related cash flows.

**Guaranteed Investment Certificate** As long as the certificate is purchased from a financial institution that is guaranteed by the federal government, there is virtually no risk that the principal or interest could be lost. Your combined federal and provincial tax rate for interest is 44 percent (29% + 15%). This means that the $100,000 investment would provide an after-tax amount calculated as follows:

| | |
|---|---|
| Interest [($100,000)(5.5%)] | $5,500 |
| Federal/Provincial Tax Payable [($5,500)(33% + 18%)] | ( 2,805) |
| After Tax Cash Flow - Guaranteed Investment Certificate | $2,695 |

**Common Stock Purchase** If you invest the $100,000 in common stock, you will be exposing yourself to a greater risk and uncertainty of cash flows than the guaranteed investment certificate alternative. There is no guarantee that the stock will pay a dividend of $5,000 during the year. There is the possibility that more or less than $5,000 will be paid. In addition, the estimated market price of at least $106,000 on December 31, 2019 is not certain. The price on that date could be higher or lower.

Assuming that the stock does pay $5,000 in dividends and you sell the shares for $106,000 on December 31, 2019, your after tax return on the investment is as follows:

| | |
|---|---|
| Dividends Received | $5,000 |
| Gross Up [(38%)($5,000)] | 1,900 |
| Taxable Dividends | $6,900 |
| Taxable Capital Gain [(1/2)($106,000 - $100,000)] | 3,000 |
| Taxable Income | $9,900 |
| Combined Tax Rate (33% + 18%) | 51% |
| Tax Payable Before Dividend Tax Credit | $5,049 |
| Dividend Tax Credit [($1,900)(6/11 + 27%)] | ( 1,549) |
| Tax Payable | $3,500 |

| | |
|---|---|
| Dividends Received | $5,000 |
| Capital Gain (100%) | 6,000 |
| Tax Payable | ( 3,500) |
| After Tax Cash Flow - Common Stock Purchase | $7,500 |

**Rental Property** If you invest the $100,000 in real estate, you will be choosing the highest risk alternative. Rental properties can require significant personal involvement if there are problems with the tenant or repairs become necessary. The transaction costs (e.g., real estate commissions and legal fees), would be much higher on this investment than on either of the other two. In addition, the real estate investment is the least liquid of the three alternatives and you might encounter difficulties in the disposition of this investment. The estimated net proceeds of $175,000 on December 31, 2019 is not certain. The net proceeds could be higher or lower.

Assuming that the property has the anticipated revenues and expenses and you net $175,000 when you sell the property on December 31, 2019, your after tax return on the investment is as follows:

| | |
|---|---|
| Gross Rents | $13,200 |
| Expenses | ( 9,600) |
| CCA (Property Sold Prior To Year End) | Nil |
| Net Rental Income | $ 3,600 |

In addition to this net rental income, you anticipate a capital gain of $10,000 ($175,000 - $165,000), of which one-half, or $5,000, would be included in your income. Based on these figures, the Tax Payable would be calculated as follows:

| | |
|---|---|
| Net Rental Income | $3,600 |
| Taxable Capital Gain | 5,000 |
| Taxable Income | $8,600 |
| Tax Rate (33% + 18%) | 51% |
| Tax Payable | $4,386 |

The total after tax cash flow would be as follows:

| | |
|---|---|
| Net Rental Income | $ 3,600 |
| Capital Gain (Cash Flow is 100% Of Gain) | 10,000 |
| Tax Payable | ( 4,386) |
| After Tax Cash Flow - Rental Property | $ 9,214 |

**Conclusion** Based purely on after tax returns, it would appear that you should acquire the rental property. However, as previously indicated, this alternative involves the most risk and uncertainty.

In choosing between the guaranteed investment certificate and the shares of Norton Ltd., the after tax cash flows from the shares are considerably higher. However, the return on the shares is made up of dividends and a potential capital gain, both of which are more uncertain than the interest on the guaranteed investment certificate. Given this, the possibility of greater than anticipated dividends and/or capital gains must be weighed against the additional risk of lower than anticipated returns.

Other factors which may influence your decision are as follows:

- The funds are locked into the investment certificate and can only be withdrawn prior to maturity at a severe interest penalty, if at all.
- The investment in common stock would give you more flexibility if you should require some of the funds before the end of the year. All or some portion of the stockholding could be sold during the year.
- Any dividends or rent that is paid will be available for your use as at the payment date. The interest will not be available to you until maturity.

## Self Study Solution Seven - 6

Ms. Smursch's minimum Net Income For Tax Purposes would be calculated as follows:

| | | |
|---|---|---|
| Income From A Business Or Profession: | | |
| Billable Hours (Given) | $345,000 | |
| December 21, 2018 Unbilled Work In Progress (Note 1) | 18,400 | |
| December 31, 2019 Unbilled Work In Progress (Note 2) | ( 8,400) | |
| Office Supplies And Office Expenses | ( 23,000) | |
| Rent | ( 60,000) | |
| Meals And Entertainment [(1/2)($18,000)] | ( 9,000) | |
| Convention Expenses (Note 3) | ( 2,400) | $260,600 |
| Property Income: | | |
| Income From Income Trust [($3.50 - $1.50)(2,500)] | | 5,000 |
| Taxable Capital Gain (Note 4) | | 8,417 |
| Minimum Net Income For Tax Purposes | | $274,017 |

**Note 1** As Sara is a professional accountant she is eligible for the use of the billed basis of recognition. However, as noted in the text, beginning in 2018, this provision is being phased out over 5 years at the rate of 20 percent per year. This means that for 2018, she was only able to defer $18,400, 80 percent of her $23,000 unbilled work in progress. This amount will have to be taken into income in 2019.

**Note 2** With respect to the December 31 unbilled work in progress, she can defer only $8,400, 60 percent of the December 31 balance of $14,000.

**Note 3** Unless the scope of Ms. Smursch's business is likely to extend to this activity in the Middle East, the costs of the Beirut convention cannot be deducted.

**Note 4** The adjusted cost base of the Realty Income Trust units would be calculated as follows:

| | |
|---|---|
| Original Cost [(2,500)($43.00] | $107,500 |
| Reinvestment Of Distribution [(2,500)($3.50)] | 8,750 |
| Tax Free Return Of Capital [(2,500)($1.50)] | ( 3,750) |
| Adjusted Cost Base | $112,500 |

The taxable capital gain on the disposition of all the units would be calculated as follows:

| | |
|---|---|
| Proceeds Of Disposition | $129,333 |
| Adjusted Cost Base | ( 112,500) |
| Capital Gain | $ 16,833 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain | $ 8,417 |

The distribution reinvestment resulted in 194.44 additional shares ($8,750 ÷ $45). However, this number is irrelevant as all of the units were sold.

## Self Study Solution Seven - 7

**Note To Instructors** This problem is somewhat unrealistic in that, under the Canada/U.K. tax treaty, it is unlikely that there would be any amounts withheld on interest payments between the two countries. Note that this problem does not contain enough information to do a complete calculation of the foreign tax credit which is not covered until Chapter 11. We have assumed that the credit is equal to the maximum 15 percent of the amount withheld.

### *Taxable Income And Tax Payable*

The amount of taxable income and tax payable resulting from the investments would be calculated as follows:

| | | |
|---|---|---|
| Interest On Term Deposit [(7%)(£200,000)($1.70)] | $23,800 | |
| Excess Withholding (See Note) | ( 2,380) | $21,420 |
| B&B Trust Distribution [($1.50)(8,000)] | $12,000 | |
| Return Of Capital [($0.50)(8,000)] | ( 4,000) | 8,000 |
| Liberty Inc. Dividends [($1.60)(2,000)] | $ 3,200 | |
| Dividend Gross Up [(38%)(3,200)] | 1,216 | 4,416 |
| Temple Capital Gain [($0.40)(2,500)] | $ 1,000 | |
| Non-Taxable One-Half | ( 500) | 500 |
| Temple Eligible Dividends [($1.00)(2,500)] | $ 2,500 | |
| Dividend Gross Up [(38%)($2,500)] | 950 | 3,450 |
| Temple Interest [($1.00)(2,500)] | | 2,500 |
| Taxable Income | | $40,286 |
| Tax Rate (29% + 16%) | | 45% |
| Tax Before Credits | | $18,129 |
| Dividend Tax Credit [($1,216 + $950)(6/11 + 30%)] | | ( 1,831) |
| Foreign Tax Credit - Note [(15%)(7%)(£200,000)($1.70)] | | ( 3,570) |
| Tax Payable | | $12,728 |

**Note - Foreign Source Property Income** As required, 100 percent of the foreign interest is included in Net Income For Tax Purposes. However, for individuals, the credit against Tax Payable that is provided under ITA 126(1) is limited to a maximum of 15 percent of the foreign source non-business income and the excess withholding is deducted. With the withholding rate at 25 percent, this deduction would be equal to $2,380 [(25% - 15%)(7%)(£200,000)($1.70)].

### *Adjusted Cost Base - B&B Trust*

The reinvestment of the $12,000 [($1.50)(8,000)] distribution at $52 per unit would acquire an additional 230.77 units. After recognizing these changes, the adjusted cost base per unit would be as follows:

$30.13 [($240,000 + $12,000 - $4,000) ÷ (8,000 + 230.77)]

### *Adjusted Cost Base - Temple Small Cap*

The reinvestment of the $6,000 [($2.40)(2,500)] distribution at $38 per unit would acquire an additional 157.89 units. After recognizing these changes, the adjusted cost base per unit would be as follows:

$39.88 [($100,000 + $6,000) ÷ (2,500 + 157.89)]

## Self Study Solution Seven - 8

### *Employment Income*

Jeremy's net employment income would be calculated as follows:

| | |
|---|---|
| Gross Wages | $74,000 |
| RPP Contributions | ( 5,600) |
| Union Dues | ( 896) |
| Net Employment Income | $67,504 |

### *Property Income*

Jeremy's property income would be calculated as follows:

| | |
|---|---|
| Eligible Dividends Received | $8,600 |
| Gross Up Of Eligible Dividends (38%) | 3,268 |
| Non-Eligible Dividends Received | 6,400 |
| Gross Up Of Non-Eligible Dividends (15%) | 960 |
| Foreign Dividends Before Withholding ($13,600 ÷ 85%) | 16,000 |
| Interest | 3,420 |
| Property Income | $38,648 |

### *Net Business Income*

Jeremy's net business income would be calculated as follows:

| | |
|---|---|
| Net Cash Flow | $187,000 |
| Principal Payments On Car Loan ($14,400 - $5,100) | 9,300 |
| Non-Deductible Interest [($5,100 - (365)($10 Daily Maximum)] | 1,450 |
| December 31 Receivables | 26,700 |
| January 1 Billed Receivables | ( 23,200) |
| December 31 Work In Process (Note 1) | 31,300 |
| January 1 Work In Process | ( 28,900) |
| December 31 Accounts Payable | ( 14,200) |
| January 1 Accounts Payable | 15,600 |
| Subtotal | $205,050 |
| CCA ($26,150 + $9,253 + $13,500) (Note 2) | ( 48,903) |
| Car Operating Costs (Already Deducted) | Nil |
| Net Business Income | $156,147 |

**Note 1** Since Jeremy is a management consultant, he was not able to use the billed basis of income recognition. This means that he is not eligible for the transitional provision related to the billed basis and must include 100 percent of his unbilled work in progress in his income.

**Note 2** The CCA would be calculated as follows:

**Class 1 CCA**

| | |
|---|---|
| January 1, 2019 UCC | $342,837 |
| Additions (Improvements) | 62,000 |
| AccII Adjustment [(50%)($62,000)] | 31,000 |
| Base For CCA | $435,837 |
| Rate | 6% |
| CCA | $ 26,150 |

As the building was acquired new and was used 100 percent for non-residential purposes, it is eligible for the 6 percent CCA rate. The fact that it was the only building owned by the business would result in it automatically being allocated to a separate class, but it must remain in a separate Class 1 to continue to qualify for the 6 percent rate.

**Class 8 CCA**

| | |
|---|---|
| January 1, 2019 UCC | $10,564 |
| Additions | 47,000 |
| Disposals - Lesser Of: | |
| • Proceeds Of Disposition = $23,200 | |
| • Capital Cost = $25,000 | ( 23,200) |
| AccII Adjustments [(50%)($47,000 - $23,200)] | 11,900 |
| Base For CCA | $46,264 |
| Rate | 20% |
| CCA | $ 9,253 |

**Class 10.1 CCA**

As the cost of the car exceeds $30,000, the addition to Class 10.1 is limited to this value. The maximum deduction for 2019 would be $13,500 [(150%)(30%)($30,000)].

### Net Income For Tax Purposes And Taxable Income

There are no Taxable Income deductions available. As a consequence, Taxable Income is equal to Net Income For Tax Purposes.

| | |
|---|---|
| Net Employment Income | $ 67,504 |
| Property Income | 38,648 |
| Net Business Income | 156,147 |
| Pension Income | 32,500 |
| Net Income For Tax Purposes And Taxable Income | $294,799 |

### Tax Payable

Tax Payable would be calculated as follows:

| | | |
|---|---|---|
| Tax On First $210,371 | | $48,719 |
| Tax On Next $84,428 ($294,799 - $210,371) At 33 Percent | | 27,861 |
| Tax Before Credits | | $76,580 |
| Tax Credits: | | |
| Basic Personal Amount (Jeremy) | ($12,069) | |
| Spouse ($12,069 - $8,400) | ( 3,669) | |
| Canada Caregiver - Sarah | ( 7,140) | |
| Jeremy's Age Credit [$7,494 - (15%)($294,799 - $37,790) | Nil | |
| Jeremy's Pension Credit | ( 2,000) | |
| EI | ( 860) | |
| CPP | ( 2,749) | |
| Canada Employment | ( 1,222) | |
| Transfer Of Spouse's Age Credit [$7,494 - (15%)($8,400 - $37,790) | ( 7,494) | |
| Transfer Of Spouse's Pension Credit | ( 2,000) | |
| Transfer Of Sarah's Disability Credit | ( 8,416) | |
| Transfer Of Samantha's Tuition Credit (Note 5) | ( 5,000) | |
| Medical Expenses (Note 6) | ( 14,548) | |
| Total Credit Base | ($67,167) | |
| Rate | 15% | ( 10,075) |
| Charitable Donations (Note 7) | | ( 756) |
| Dividend Tax Credit On: | | |
| Eligible Dividends [(6/11)($3,268)] | | ( 1,783) |
| Non-Eligible Dividends [(9/13)($960)] | | ( 665) |
| Foreign Tax Credit - Amount Withheld [(15%)($16,000)] | | ( 2,400) |
| Federal Tax Payable | | $60,901 |

**Note 5** Samantha's child support received is not included in her Net Income For Tax Purposes. Given this, Samantha has Net Income For Tax Purposes of nil and would qualify as a dependant of Jeremy's. Even though she lives with Jeremy, he cannot claim the Canada caregiver tax credit for her or her children as they are not mentally or physically infirm.

The maximum transfer of the tuition credit would be the lesser of:

- The actual tuition of $16,400.
- The absolute maximum of $5,000.

**Note 6** The claim for medical expenses is determined as follows:

| | | |
|---|---|---|
| Medical Expenses Of Jeremy And Sandra ($4,000 + $1,700) | | $ 5,700 |
| Reduced By The Lesser Of: | | |
| • [(3%)($294,799)] = $8,844 | | |
| • 2019 Threshold Amount = $2,352 | | ( 2,352) |
| Balance Before Dependants 18 And Over | | $ 3,348 |
| Sarah's Medical Expenses | $9,400 | |
| Reduced By The Lesser Of: | | |
| • $2,352 | | |
| • [(3%)(Nil)] = Nil | Nil | 9,400 |
| Samantha's Medical Expenses | $ 1,800 | |
| Reduced By The Lesser Of: | | |
| • $2,352 | | |
| • [(3%)(Nil)] = Nil | Nil | 1,800 |
| Total Medical Expense Claim | | $14,548 |

**Note 7** Jeremy's charitable donations tax credit would be calculated as follows:

| | |
|---|---|
| 15 Percent Of $200 | $ 30 |
| 33 Percent Of The Lesser Of: | |
| ($2,400 - $200) = $2,200 | |
| $294,799 - $210,371 = $84,428 | 726 |
| 29 Percent Of [($2,400 - ($200 + $2,200)] | Nil |
| Total Credit | $756 |

## Self Study Solution Seven - 9

### *Net Business Income*

Derek's Net Business Income is calculated as follows:

| | | |
|---|---|---|
| Accounting Net Income | | $211,000 |
| Additions: | | |
| Amortization Expense | $18,000 | |
| Meals And Entertainment (Note 1) | 5,750 | |
| Automobile Operating Costs - Personal (Note 2) | 1,350 | 25,100 |
| | | $236,100 |
| Deductions: | | |
| Capital Cost Allowance | | |
| Automobile (Note 3) | ($ 9,703) | |
| Furniture And Fixtures (Note 4) | ( 11,100) | |
| Building [(6%)($450,000)] (Note 5) | ( 27,000) | ( 47,803) |
| Net Business Income For Tax Purposes | | $188,297 |

**Note 1** As the business deducted 100 percent of the meals and entertainment costs, the non-deductible one-half of this amount needs to be added back to arrive at Net Business Income For Tax Purposes.

**Note 2** As the business deducted 100 percent of the automobile operating costs, the portion related to Derek's personal use must be added back. This amount would be $1,350 [($4,800)(9,000 ÷ 32,000)].

**Note 3** The addition to UCC for the car would be limited to $30,000 and it would be allocated to a separate Class 10.1. Maximum CCA for 2019 would be $13,500 [(150%)(30%)($30,000)]. However, the business can only deduct $9,703 [($13,500)(23,000 ÷ 32,000)].

**Note 4** CCA for Class 8 would be calculated as follows:

| | |
|---|---|
| UCC January 1, 2019 | $42,000 |
| Additions | 12,000 |
| Disposals - Lesser Of: | |
| Proceeds Of Disposition = $3,000 | |
| Capital Cost = $10,000 | ( 3,000) |
| AccII Adjustment [(50%)($12,000 - $3,000)] | 4,500 |
| Base For CCA | $55,500 |
| Rate | 20% |
| Class 8 CCA | $11,100 |

**Note 5** As the building was acquired new and was used 100 percent for non-residential purposes, it is eligible for the 6 percent CCA rate. The fact that it was the only building owned by the business would result in it automatically being allocated to a separate class, but it must remain in a separate Class 1 to continue to qualify for the 6 percent rate.

### *Property Income*

Derek's property income is calculated as follows:

| | |
|---|---:|
| Eligible Dividends On Breax | $ 8,000 |
| Gross Up On Eligible Dividends [(38%)($8,000)] | 3,040 |
| Realco Income Trust Units [(5,000)($1.50)] | 7,500 |
| Debt Securities (Note 6) | 12,000 |
| Foreign Term Deposit (Note 7) | 15,000 |
| Total Property Income | $45,540 |

**Note 6** Derek would have to recognize $8,000 [(8%)($100,000)] in interest on the July 1, 2019 anniversary of the debt security. In addition, because a $12,000 payment is received on December 31, 2019, he would have to recognize an additional $4,000 ($12,000, less the $8,000 recognized on the anniversary date).

**Note 7** As non-business income is involved, the tax credit will be limited to $3,000 [(15%)($20,000)]. The remaining $5,000 ($8,000 - $3,000) can be deducted against the interest. This leaves an inclusion of $15,000 ($20,000 - $5,000).

### *Capital Gain*

The adjusted cost base of the Breax shares that were sold was $52 ($130,000 ÷ 2,500). Given this, the capital gain on the Breax common shares would be calculated as follows:

| | |
|---|---:|
| Proceeds [($65)(1,000)] | $65,000 |
| Adjusted Cost Base [($52)(1,000)] | ( 52,000) |
| Capital Gain | $13,000 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain | $ 6,500 |

### *Net Income For Tax Purposes And Taxable Income*

There are no Taxable Income deductions available. As a consequence, Taxable Income is equal to Net Income For Tax Purposes.

| | |
|---|---:|
| Net Business Income | $188,297 |
| Total Property Income | 45,540 |
| Taxable Capital Gain | 6,500 |
| Net Income For Tax Purposes And Taxable Income | $240,337 |

### *Tax Payable*

Tax Payable would be calculated as follows:

| | | |
|---|---|---|
| Tax On First $210,371 | | $48,719 |
| Tax On Next $29,966 ($240,337 - $210,371) At 33 Percent | | 9,889 |
| Tax Before Credits | | $58,608 |
| Tax Credits: | | |
| Basic Personal Amount (Derek) | ($12,069) | |
| Spouse ($12,069 - $9,500) | ( 2,569) | |
| Canada Caregiver For A Child | ( 2,230) | |
| Disability Transferred From Brad | ( 8,416) | |
| Disability Supplement For Brad (Note 8) | Nil | |
| First Time Home Buyers | ( 5,000) | |
| Transfer Of Bill's Tuition Credit (Note 9) | ( 5,000) | |
| Medical Expenses (Note 10) | ( 18,648) | |
| Total Credit Base | ($53,932) | |
| Rate | 15% | ( 8,090) |
| Dividend Tax Credit On Eligible Dividends [(6/11)($3,040)] | | ( 1,658) |
| Foreign Tax Credit [(15%)($20,000)] | | ( 3,000) |
| Federal Tax Payable | | $45,860 |

**Note 8** Since Brad's medical expenses claimed for the medical expense tax credit total more than $7,784 ($4,909 + $2,875), Derek cannot claim the disability supplement for him.

**Note 9** As Bill's income is below the basic credit amount of $12,069, he cannot use any of his available tuition credit. Given this, the maximum transfer is the lesser of:

- The actual tuition of $8,500.
- The absolute maximum of $5,000.

**Note 10** The base for the medical expense tax credit is calculated as follows:

| | | |
|---|---|---|
| Medical Expenses Of Derek, Emily, Brad And Barbara ($1,400 + $1,600 + $11,400 + $2,300) | | $ 16,700 |
| Lesser Of: | | |
| • [(3%)($240,337)] = $7,210 | | |
| • 2019 Threshold Amount = $2,352 | | ( 2,352) |
| Balance Before Dependants 18 And Over | | $ 14,348 |
| Bill's Medical Expenses | $4,600 | |
| Reduced By The Lesser Of: | | |
| • $2,352 | | |
| • [(3%)($10,000)] = $300 | ( 300) | 4,300 |
| Medical Expense Tax Credit Base | | $18,648 |

## Chapter 7 Learning Objectives

After completing Chapter 7, you should be able to:

1. Explain the nature of property income (paragraph [P hereafter] 7-1 to 7-5).
2. Describe the rules applicable to the deductibility of interest payments and be able to apply these rules to various types of borrowing (P 7-6 to 7-28).
3. Apply the provisions relating to the treatment of discount and premium on long-term issued debt (P 7-29 to 7-37).
4. Calculate the taxable amount of interest income for both individuals and corporations (P 7-38 to 7-45).
5. Explain the tax treatment of discounts and premiums on long-term debt holdings (P 7-46 and 7-47).

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6. Apply the provisions related to accrued interest at the time of transfer of debt obligations (P 7-48 to 7-50).
7. Describe tax procedures for royalties and payments based on production or use (P 7-51 to 7-53).
8. Calculate net rental income (P 7-54 to 7-65).
9. Apply the gross up and tax credit procedures to determine the tax consequences of receiving eligible and non-eligible dividend income (P 7-66 to 7-95).
10. Compare the after-tax returns from various types of investments (P 7-96 to 7-97).

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11. Discuss the provisions relating to investments in income trusts (P 7-98 to 7-111).
12. Discuss the provisions relating to investments in mutual funds (P 7-112 to 7-122).
13. Explain the general treatment of stock dividends and capital dividends (P 7-123 to 7-128).
14. Explain the general tax treatment of withholdings on foreign source business and non-business income (P 7-129 to 7-132).
15. Explain the general treatment of shareholder benefits (P 7-133 to 7-135).

# CHAPTER 8

## How To Work Through Chapter 8

We recommend the following approach in dealing with the material in this chapter:

**Economic Background And General Rules For Capital Gains Taxation**

- Read paragraph 8-1 to 8-30 (in the textbook).
- Do Exercises Eight-1 and Eight-2 (in the textbook) and check the solutions in this Study Guide.
- Read paragraph 8-31 to 8-36.

**Identical Properties**

- Read paragraph 8-37 to 8-38.
- Do Exercise Eight-3 and check the solution in this Study Guide.
- Do Self Study Problem Eight-1 which is available on MyLab and check the solution in this Study Guide.

**Partial Dispositions And Warranties On Capital Assets**

- Read paragraph 8-39 to 8-41.
- Do Exercise Eight-4 and check the solution in this Study Guide.
- Do Self Study Problem Eight-2 and check the solution in this Study Guide.

**Capital Gains Reserves**

- Read paragraph 8-42 to 8-61.
- Do Exercise Eight-5 and check the solution in this Study Guide.
- Do Self Study Problems Eight-3 and Eight-4 and check the solutions in this Study Guide.

**Bad Debts On Sales Of Capital Property**

- Read paragraph 8-62 to 8-63.
- Do Exercise Eight-6 and check the solution in this Study Guide.
- Do Self Study Problems Eight-5 and Eight-6 and check the solutions in this Study Guide.

**Special Rule For Sales Of Real Property**

- Read paragraph 8-64 to 8-71.
- Do Exercise Eight-7 and check the solution in this Study Guide.

**Principal Residence**

- Read paragraph 8-72 to 8-81.
- Do Exercises Eight-8 and Eight-9 and check the solutions in this Study Guide.
- Do Self Study Problem Eight-7 and check the solution in this Study Guide.
- Read paragraph 8-82 to 8-86.

**Personal Use And Listed Personal Property**

- Read paragraph 8-87 to 8-94.
- Do Exercise Eight-10 and check the solution in this Study Guide.
- Do Self Study Problem Eight-8 and check the solution in this Study Guide.

### Gains And Losses On Foreign Currency

- Read paragraph 8-95 to 8-106.
- Do Exercise Eight-11 and check the solution in this Study Guide.
- Do Self Study Problem Eight-9 and check the solution in this Study Guide.

### Options

- Read paragraph 8-107 to 8-112.

### Deemed Dispositions - Change In Use Including Principal Residences

- Read paragraph 8-113 to 8-121.
- Do Exercise Eight-12 and check the solution in this Study Guide.
- Read paragraph 8-122 to 8-128.
- Do Exercise Eight-13 and check the solution in this Study Guide.
- Read paragraph 8-129 to 8-130.
- Do Exercise Eight-14 and check the solution in this Study Guide.
- Do Self Study Problems Eight-10 and Eight-11 and check the solutions in this Study Guide.
- Read paragraph 8-131.

### Deemed Dispositions - Departures From Canada

- Read paragraph 8-132 to 8-133.
- Do Exercises Eight-15 and Eight-16 and check the solutions in this Study Guide.
- Do Self Study Problem Eight-12 and check the solution in this Study Guide.

### Deferral Provisions On Small Business Investments

- Read paragraph 8-134 to 8-136.
- Do Exercise Eight-17 and check the solution in this Study Guide.
- Do Self Study Problem Eight-13 and check the solution in this Study Guide.

### Deferral Provisions On Replacement Property For Capital Gains And CCA

- Read paragraph 8-137 to 8-153.
- Do Exercise Eight-18 and check the solution in this Study Guide.

### Replacement Property - Combined Use Of Deferral Elections

- Read paragraph 8-154 to 8-165.
- Do Exercise Eight-19 and check the solution in this Study Guide.

### Capital Gains And Tax Planning

- Read paragraph 8-166 to 8-168.
- Do Self Study Problems Eight-14 to Eight-18 and check the solutions in this Study Guide.

### To Complete This Chapter

- If you would like more practice in problem solving, do the Supplementary Self Study Problems for the chapter. These problems and solutions are available on MyLab.
- Review the Key Terms Used In This Chapter in the textbook at the end of Chapter 8. Consult the Glossary for the meaning of any key terms you do not know.
- Test yourself with the Chapter 8 Glossary Flashcards available on MyLab.
- Ensure you have achieved the Chapter 8 Learning Objectives listed in this Study Guide.
- As a review, we recommend you view the PowerPoint presentation for Chapter 8 that is on MyLab.

### Practice Examination

Write the Practice Examination for Chapter 8 that is on MyLab. Mark your examination using the Practice Examination Solution that is also on MyLab.

# Solutions to Chapter Eight Exercises

### *Exercise Eight - 1 Solution*

The capital cost of this Class 1 asset would be $3,500,000 ($5,600,000 - $600,000 - $1,500,000). As it is used 100 percent for non-residential purposes and is in a separate Class 1, the maximum CCA for 2019 would be $315,000 [(150%)($3,500,000)(6%)].

### *Exercise Eight - 2 Solution*

| | |
|---|---|
| Proceeds Of Disposition [(1,000)($14.50)] | $14,500 |
| Adjusted Cost Base [(1,000)($23.00)] | ( 23,000) |
| Total Capital Loss | ($ 8,500) |
| Disallowed Portion [(600)($23 - $14.50)] | 5,100 |
| Adjusted Capital Loss | ($ 3,400) |
| Inclusion Rate | 1/2 |
| Allowable Capital Loss | ($ 1,700) |

The adjusted cost base of the acquired shares would be calculated as follows:

| | |
|---|---|
| Purchase Price [(600)($13.75)] | $8,250 |
| Disallowed Loss [(600)($23 - $14.50)] | 5,100 |
| Adjusted Cost Base | $13,350 |

### *Exercise Eight - 3 Solution*

The relevant average cost calculations are as follows:

| Acquisition Date Or Sale Date | Shares Purchased (Sold) | Cost Per Share | Total Cost | Average Cost/Share |
|---|---|---|---|---|
| January 15, 2018 | 650 | $23.50 | $15,275 | |
| March 12, 2018 | 345 | 24.25 | 8,366 | |
| Subtotal | 995 | | $23,641 | $23.76 |
| September 15, 2018 | ( 210) | $23.76 | ( 4,990) | |
| Subtotal | 785 | | $18,651 | |
| February 14, 2019 | 875 | $26.75 | 23,406 | |
| Subtotal | 1,660 | | $42,057 | $25.34 |
| October 1, 2019 | ( 340) | $25.34 | ( 8,616) | |
| End Of Year Balances | 1,320 | | $33,441 | |

Ms. Montrose's taxable capital gain for 2018 is calculated as follows:

| | |
|---|---|
| Proceeds Of Disposition [($25.50)(210)] | $5,355 |
| Adjusted Cost Base [($23.76)(210)] | ( 4,990) |
| Capital Gain | $ 365 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain | $ 183 |

Ms. Montrose's taxable capital gain for 2019 is calculated as follows:

| | |
|---|---|
| Proceeds Of Disposition [($29.50)(340)] | $10,030 |
| Adjusted Cost Base [($25.34)(340)] | ( 8,616) |
| Capital Gain | $ 1,414 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain | $ 707 |

### Exercise Eight - 4 Solution

For 2018, there will be a taxable capital gain of $27,500 [(1/2)($292,000 - $237,000)]. For 2019, there will be an allowable capital loss of $2,400 [(1/2)($4,800)]. This allowable capital loss will only be deductible in the determination of 2019 Net Income For Tax Purposes, to the extent that there are 2019 taxable capital gains. Any undeducted loss is subject to the carry over provisions described in Chapter 11. This would include carrying the loss back to apply against the 2018 taxable capital gain.

### Exercise Eight - 5 Solution

Mr. Goodson's capital gain on this transaction is $71,800 ($382,000 - $293,000 - $17,200) and the uncollected proceeds are $300,000 ($382,000 - $82,000). Given this, the maximum reserve for 2018 is $56,387, the lesser of:

| | |
|---|---|
| • [($71,800)($300,000 ÷ $382,000)] | $56,387 (Reserve) |
| • [($71,800)(20%)(4 - 0)] | $57,440 (Reserve) |

His taxable capital gain for 2018 is $7,707 [(1/2)($71,800 - $56,387)].

At the end of 2019, the uncollected proceeds are $240,000 ($300,000 - $60,000). Based on this, the capital gain to be recognized for 2019 would be as follows:

| | |
|---|---|
| 2018 Reserve Added To Income | $56,387 |
| 2019 Reserve - Lesser Of: | |
| • [($71,800)($240,000 ÷ $382,000)] = $45,110 | |
| • [($71,800)(20%)(4 - 1)] = $43,080 | ( 43,080) |
| 2019 Capital Gain | $13,307 |

His taxable capital gain for 2019 is $6,654 [(1/2)($13,307)].

### Exercise Eight - 6 Solution

For 2018, there will be an allowable capital loss of $7,500 [(1/2)($110,000 - $125,000)]. For 2019, there will be an allowable capital loss of $17,500 [(1/2)(Nil - $35,000)]. The total allowable capital loss of $25,000 ($7,500 + $17,500) over the two years is equivalent to the allowable capital loss that would have resulted if the property had been sold for cash of $75,000. The capital loss would equal $50,000 ($125,000 - $75,000) and the allowable capital loss would be $25,000 [(1/2)($50,000)].

These allowable capital losses will only be deductible against taxable capital gains. However, they can be carried over to other years in which the taxpayer has taxable capital gains and deducted in the determination of Taxable Income. (See Chapter 11.)

### Exercise Eight - 7 Solution

A comparison of the tax effects for Part 1 and Part 2 is as follows:

| (See Following Explanations) | **Part 1** | **Part 2** |
|---|---|---|
| Building - Fair Market Value | $500,000 | |
| Building - Deemed Proceeds | | $615,000 |
| UCC | ( 615,000) | ( 615,000) |
| Terminal Loss | ($115,000) | Nil |

| (See Following Explanations) | Part 1 | Part 2 |
|---|---|---|
| Land - Fair Market Value | $750,000 | |
| Land - Deemed Proceeds | | |
| ($1,250,000 - $615,000) | | $635,000 |
| Adjusted Cost Base | ( 425,000) | ( 425,000) |
| Capital Gain | $325,000 | $210,000 |
| Inclusion Rate | 1/2 | 1/2 |
| Taxable Capital Gain | $162,500 | $105,000 |
| Terminal Loss | ( 115,000) | Nil |
| Net Income Inclusion | $ 47,500 | $105,000 |

**Part 1 Explanation** In the absence of the special rule, there would be a taxable capital gain of $162,500 on the land. This would be reduced by the $115,000 ($615,000 - $500,000) terminal loss on the building, resulting in a net income inclusion of $47,500.

**Part 2 Explanation** ITA 13(21.1)(a) modifies the results in such situations by deeming the proceeds of disposition for the building to be:

The Lesser Of:

| | | |
|---|---|---|
| • The FMV of the land and building | $1,250,000 | |
| Reduced By The Lesser Of: | | |
| • The ACB of the land = $425,000 | | |
| • The FMV of the land = $750,000 | ( 425,000) | $825,000 |
| • The Greater Of: | | |
| • The FMV of the building = $500,000 | | |
| • The Lesser Of: | | |
| The cost of the building = $930,000 | | |
| The UCC of the building = $615,000 | | $615,000 |

With the building proceeds at $615,000, the terminal loss is eliminated. The $635,000 deemed proceeds for the land result in a capital gain of $210,000. In effect, this eliminates the terminal loss of $115,000 by reducing the capital gain by the same amount (from $325,000 to $210,000) and increases the net income inclusion by one-half of this amount or $57,500 ($105,000 - $47,500).

### *Exercise Eight - 8 Solution*

There would be no tax consequences due to the sales. There would be a capital gain on the first sale of $20,500 ($109,500 - $89,000). This gain could be eliminated by designating the first property as his principal residence for the six years 2010 through 2015. The gain reduction would be calculated as follows:

$$\left(\$20{,}500 \times \frac{(6+0)\,*}{6}\right) = \underline{\underline{\$20{,}500}} \quad (\textbf{Reduction}, \text{ Not Gain})$$

* Although the gain reduction formula includes a +1 in the numerator, the numerator cannot exceed the denominator as the gain reduction cannot be larger than the total capital gain.

The $26,000 ($178,000 - $152,000) capital gain on the second home could be eliminated by designating the second property as his principal residence for the years 2016 through 2019 and adding the plus one in the numerator. The gain reduction would be calculated as follows:

$$\left(\$26{,}000 \times \frac{(4+1)}{5}\right) = \underline{\underline{\$26{,}000}} \quad (\textbf{Reduction}, \text{ Not Gain})$$

### *Exercise Eight - 9 Solution*

The total gain on the two properties can be calculated as follows:

| | City Home (12 Years) | Cottage (9 Years) |
|---|---|---|
| Sales Price | $198,000 | $143,500 |
| Adjusted Cost Base | ( 126,000) | ( 85,000) |
| Total Capital Gain | $ 72,000 | $ 58,500 |

In this example, the years 2011 through 2019 could be allocated to either property. This raises the question of which property should be the designated the principal residence during these years. If both properties had been owned for the same length of time, you would simply allocate the number of years owned, less 1 year, to the property with the larger gain. However, that is not the case here. Given the different ownership periods, the optimum solution requires the calculation of annual increases in value for each property.

The annual calculations are as follows:

| | |
|---|---|
| Annual Gain - City Home ($72,000 ÷ 12) | $6,000 |
| Annual Gain - Cottage ($58,500 ÷ 9) | $6,500 |

Given these values, the years 2012 through 2019 (1 year less than owned) should be allocated to the cottage. When these 8 years are combined with the plus 1 in the numerator of the reduction formula, the $58,500 gain on the cottage will be completely eliminated. This leaves the years 2008 through 2011 for the Ottawa house, resulting in the following gain reduction:

$$\left(\$72{,}000 \times \frac{(4+1)}{12}\right) = \underline{\underline{\$30{,}000}} \text{ (**Reduction**, Not Gain)}$$

This will leave a total capital gain on the sale of the two properties of $42,000 ($58,500 - $58,500 + $72,000 - $30,000).

### *Exercise Eight - 10 Solution*

The results would be as follows:

| | Personal Use Property | Listed Personal Property |
|---|---|---|
| Gain On Sailboat ($68,000 - $43,000) | $25,000 | |
| Gain On Oil Painting ($25,000 - $1,000) | | $24,000 |
| Loss On Personal Automobile | Nil | |
| Loss On Necklace ($18,000 - $46,000) | | ( 28,000) |
| Capital Gain | $25,000 | Nil |
| Inclusion Rate | 1/2 | N/A |
| Net Taxable Capital Gain | $12,500 | Nil |

The only tax consequence of these dispositions is a taxable capital gain of $12,500 [(1/2)($25,000)]. The gain on the oil painting is completely eliminated by the loss on the necklace. As this loss on the necklace is greater than the gain on the painting, there is a listed personal property loss carry over of $2,000 [(1/2)($28,000 - $24,000)].

### *Exercise Eight - 11 Solution*

In 2018, as a result of his share purchase, Mr. Pratt will have an exchange gain of $612 [(450)(TT$68)(C$0.23 - C$0.21)]. As this qualifies as an ITA 39(2) foreign currency capital gain, he will only include $206 [(1/2)($612 - $200)] of this in his Net Income For Tax Purposes.

In 2019, there will be a capital gain on the sale of $1,170 {[(450)(TT$96)(C$0.19)] - [(450)(TT$68)(C$0.23)]}. None of this gain qualifies under ITA 39(2), so there would be no

$200 exclusion. Mr. Pratt's 2019 Net Income For Tax Purposes will include $585 [(1/2)($1,170)] of this gain.

### Exercise Eight - 12 Solution

The change in use will trigger capital gains on the land and building as follows:

| | Land | Building |
|---|---:|---:|
| Proceeds Of Disposition | $120,000 | $111,000 |
| Adjusted Cost Base | ( 20,000) | ( 23,000) |
| Capital Gain | $100,000 | $ 88,000 |
| Inclusion Rate | 1/2 | 1/2 |
| Taxable Capital Gain | $ 50,000 | $ 44,000 |

For capital gains purposes, the new capital cost will be $111,000 for the building and $120,000 for the land.

As the change is from personal to business use and the fair market value is greater than the cost, the new UCC for the building will be its cost, plus one-half of the difference between the fair market value and the cost. The relevant CCA calculation is as follows:

| | |
|---|---:|
| Original Cost | $23,000 |
| Bump Up [(1/2)($111,000 - $23,000)] | 44,000 |
| Cost For CCA Purposes = UCC | $67,000 |
| One-Half Net Additions | ( 33,500) |
| CCA Base | $33,500 |
| Rate | 4% |
| 2019 CCA | $ 1,340 |

Note that for individuals, the calendar year is considered the fiscal year for property income purposes. As a consequence, there is no adjustment for a short fiscal period in the year of acquisition. Also note that, the half-year rule is generally not applicable to non-arm's length transfers if the transferor used the property as a depreciable property prior to the transfer. The cottage was not previously used as a depreciable property and, as a result, the half-year provisions are applicable.

### Exercise Eight - 13 Solution

**No ITA 45(2) Election** The 2018 change in use would be treated as a deemed disposition/re-acquisition at the fair market value of $210,000. As the home was personal use property, the $10,000 loss ($210,000 - $220,000) would not be deductible.

The maximum CCA for 2018 would be $4,200 [($210,000)(4%)(1/2)]. This would result in a net rental income for 2018 of $4,800 ($21,600 - $12,600 - $4,200).

When the property is sold in 2019, she would have a taxable capital gain of $67,500 [($345,000 - $210,000)(1/2)]. In addition, there would be recapture of CCA of $4,200, the amount of CCA taken in 2018 for a total income inclusion of $71,700 ($67,500 + $4,200).

**ITA 45(2) Election** If she did not take CCA in 2018, her net rental income would be $9,000 ($21,600 - $12,600), $4,200 higher than when no ITA 45(2) election is made. However, she could then elect under ITA 45(2) and this means that the property could continue to be designated as her principal residence in 2019. Given this, the capital gain could be eliminated by the principal residence deduction. This is clearly a better alternative as shown in the following table:

| | No Election | ITA 45(2) Election |
|---|---|---|
| 2018 Income | $ 4,800 | $9,000 |
| 2019 Income | 71,700 | Nil |
| Total | $76,500 | $9,000 |

### Exercise Eight - 14 Solution

**No ITA 45(3) Election** The maximum CCA for 2018 would be $7,500 [($375,000)(4%)(1/2)]. Deducting this amount would result in a 2018 net rental income of $2,300 ($9,800 - $7,500).

Because he has deducted CCA for this year, he cannot treat the property as his principal residence and, when he moves in on January 1, 2019, the change in use will create a deemed disposition/re-acquisition at the fair market value of $450,000. This will result in a taxable capital gain of $37,500 [($450,000 - $375,000)(1/2)]. There would also be recapture of the $7,500 of CCA taken in 2018.

When he sells the property at the end of the year for $510,000, there will be an additional taxable capital gain of $30,000 [($510,000 - $450,000)(1/2)]. However, as he lived in the condominium during 2019, this gain would be eliminated through the use of the principal residence exemption. This would leave a 2019 income inclusion of $45,000 ($37,500 + $7,500 + $30,000 - $30,000).

**ITA 45(3) Election** If he does not take CCA in 2018, his net rental income will be $9,800. However, if he makes the ITA 45(3) election, the unit can be designated as his principal residence for both 2018 and 2019. This means that there will be no additional income in 2019. This is clearly a better alternative as shown in the following table:

| | No Election | ITA 45(3) Election |
|---|---|---|
| 2018 Income | $ 2,300 | $9,800 |
| 2019 Income | 45,000 | Nil |
| Total | $47,300 | $9,800 |

### Exercise Eight - 15 Solution

There would be a deemed disposition on his departure, leaving him liable for the taxes on a $55,000 [(1/2)($1,030,000 - $920,000)] taxable capital gain.

### Exercise Eight - 16 Solution

As real property is exempt from the deemed disposition provision contained in ITA 128.1(4)(b), there would be no tax consequences with respect to the rental property at the time of Ms. Twain's departure. However, real property is Taxable Canadian Property and, as a consequence, as explained in Chapter 1, she would be liable for Canadian taxes on both recapture and capital gains resulting from a subsequent sale of the property, even after she becomes a non-resident.

### Exercise Eight - 17 Solution

The capital gain would be calculated as follows:

| | |
|---|---|
| Proceeds Of Disposition | $1,350,000 |
| Adjusted Cost Base | ( 750,000) |
| Capital Gain | $ 600,000 |

As the lesser of the proceeds of disposition and the cost of the replacement shares is the $1,200,000 cost of the replacement shares, the maximum deferral would be $533,333 [($600,000)($1,200,000 ÷ $1,350,000)].

The adjusted cost base of the new shares would be calculated as follows:

| | |
|---|---|
| Initial Cost | $1,200,000 |
| Deferred Capital Gain | ( 533,333) |
| Adjusted Cost Base | $ 666,667 |

### *Exercise Eight - 18 Solution*

The Company would have to record recapture of $750,000 ($650,000 - $1,400,000) for 2018. This is reversed during 2019 by electing under ITA 13(4). Since the replacement cost of the new building exceeds the normal recapture of CCA, the amended recapture of CCA is nil. Using the ITA 13(4) formula, the amended 2018 recapture of CCA would be calculated as follows:

| | | |
|---|---|---|
| UCC Balance | | $650,000 |
| Deduction: | | |
| Lesser Of: | | |
| • Proceeds Of Disposition = $1,400,000 | | |
| • Capital Cost = $1,500,000 | $1,400,000 | |
| Reduced By The Lesser Of: | | |
| • Normal Recapture = $750,000 | | |
| • Replacement Cost = $2,350,000 | ( 750,000) | ( 650,000) |
| Recapture Of CCA (Amended) | | Nil |

The result is that the UCC of the replacement building would be limited to $1,600,000 ($2,350,000 - $750,000). This also reflects the economic substance of the replacement transaction ($650,000 + $2,350,000 - $1,400,000 = $1,600,000).

### *Exercise Eight - 19 Solution*

As the replacement did not occur until 2019, Hadfeld's 2018 tax return will include a capital gain of $225,000 ($950,000 - $725,000), of which one-half or $112,500 is taxable, and recapture of $101,850 ($725,000 - $623,150).

Since the cost of the replacement property exceeded the proceeds of disposition for the old property, these amounts can be reversed in 2019 through a 2018 amended return. The deemed capital cost and UCC of the new building are as follows:

| | |
|---|---|
| Actual Capital Cost | $980,000 |
| Capital Gain Deferred By Election ($950,000 - $725,000) | ( 225,000) |
| Deemed Capital Cost | $755,000 |
| Recapture Deferred By Election ($725,000 - $623,150) | ( 101,850) |
| 2019 UCC | $653,150 |

Each of these amounts are $30,000 more than the old capital cost and UCC. This reflects the $30,000 ($980,000 - $950,000) over and above the insurance proceeds that the Company spent on replacing the building.

## Self Study Solution Eight - 1

***Part A***

The total cost of the 1,222 shares remaining on December 31, 2019 would be $17,077. This is calculated in the following table:

| Acquisition Or Sale Date | Shares Purchased (Sold) | Cost Per Share | Total Cost | Average Cost/Share |
|---|---|---|---|---|
| March 2013 | 650 | $11.00 | $ 7,150 | |
| September, 2014 | 922 | 13.00 | 11,986 | |
| May, 2016 | 480 | 17.00 | 8,160 | |
| Subtotal | 2,052 | | $27,296 | $13.30 |
| November, 2016 Sale | ( 610) | $13.30 | ( 8,113) | |
| July, 2019 | 240 | 18.00 | 4,320 | |
| Subtotal | 1,682 | | $23,503 | $13.97 |
| October, 2019 | ( 460) | $13.97 | ( 6,426) | |
| December 31, 2019 Balances | 1,222 | | $17,077 | |

***Part B***

The average cost of the shares sold during July, 2019 would be calculated as follows:

| | |
|---|---|
| April, 2018 Purchase [(2,200)($12)] | $26,400 |
| December, 2018 Purchase [(1,450)($17)] | 24,650 |
| Total Cost | $51,050 |
| Average Cost ($51,050 ÷ 3,650) | $13.99 |

Given this average cost, the taxable capital gain on the July, 2019 sale of shares would be calculated as follows:

| | |
|---|---|
| Proceeds [(2,840)($22)] | $62,480.00 |
| Cost [(2,840)($13.99)] | ( 39,731.60) |
| Capital Gain | $22,748.40 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain | $11,374.20 |

## Self Study Solution Eight - 2

No recognition can be given to the warranty at the time the land is sold. This means that a taxable capital gain of $600,000 [(1/2)($2,600,000 - $1,400,000)] will result from this sale. However, since no reduction in the capital gain can be made to reflect potential outlays under the warranty, the subsequent outlays that are required under the warranty agreement will be treated as a capital loss. Thus, the $1,040,000 payment that is required in 2019 will result in a $520,000 [(1/2)($1,040,000)] allowable capital loss.

This allowable capital loss must first be deducted against taxable capital gains that occur in 2019. If such gains are not sufficient to absorb the loss, some or all of the $520,000 can be carried back to 2018 to be applied against the gain that was recognized when the sale occurred.

Any loss that is not carried back can be carried forward indefinitely and applied against future capital gains. (Loss carry overs are covered in Chapter 11.)

## Self Study Solution Eight - 3

The capital gain on the two tracts of land would be calculated as follows:

| | Tract A | Tract B |
|---|---|---|
| Proceeds Of Disposition | $127,000 | $106,000 |
| Adjusted Cost Base | ( 71,000) | ( 87,000) |
| Capital Gain | $ 56,000 | $ 19,000 |

### *2019 Solution*

At the end of 2019, the proceeds not due for Tract A is $110,000 ($127,000 - $17,000). The corresponding figure for Tract B is $74,000 ($106,000 - $32,000).

The minimum taxable capital gain to be included in Ms. Helm's income for 2019 would be calculated as follows:

| | Tract A | Tract B |
|---|---|---|
| Total Capital Gain | $ 56,000 | $ 19,000 |
| Maximum Reserve For 2019: | | |
| Tract A - Lesser Of: | | |
| [($56,000)($110,000 ÷ $127,000)] = $48,504 | | |
| [($56,000)(20%)(4)] = $44,800 | ( 44,800) | |
| Tract B - Lesser Of: | | |
| [($19,000)($74,000 ÷ $106,000)] = $13,264 | | |
| [($19,000)(20%)(4)] = $15,200 | | ( 13,264) |
| Subtotal | $ 11,200 | $ 5,736 |
| Inclusion Rate | 1/2 | 1/2 |
| 2019 Inclusion | $ 5,600 | $ 2,868 |

### *2020 Solution*

At the end of 2020, the proceeds not due for Tract A is $85,000 ($110,000 - $25,000). The proceeds not due for Tract B are not changed from 2019.

The minimum taxable capital gain to be included in Ms. Helm's income for 2020 would be calculated as follows:

| | Tract A | Tract B |
|---|---|---|
| 2019 Reserve Added Back | $ 44,800 | $ 13,264 |
| 2020 Reserve: | | |
| Tract A - Lesser Of: | | |
| [($56,000)($85,000 ÷ $127,000)] = $37,480 | | |
| [($56,000)(20%)(3)] = $33,600 | ( 33,600) | |
| Tract B - Lesser Of: | | |
| [($19,000)($74,000 ÷ $106,000)] = $13,264 | | |
| [($19,000)(20%)(3)] = $11,400 | | ( 11,400) |
| Subtotal | $ 11,200 | $ 1,864 |
| Inclusion Rate | 1/2 | 1/2 |
| 2020 Inclusion | $ 5,600 | $ 932 |

# Self Study Solution Eight - 4

## Capital Gain And Recapture

The immediate tax consequences of the sale can be calculated as follows:

| | Land | Building | Total Gain |
|---|---|---|---|
| Proceeds Of Disposition | $300,000 | $1,200,000 | |
| Adjusted Cost Base/Capital Cost | ( 250,000) | ( 950,000) | |
| Capital Gain | $ 50,000 | $ 250,000 | $300,000 |

| | Building |
|---|---|
| Opening UCC Balance Of Class 1 | $790,742 |
| Lesser Of: | |
| • Proceeds Of Disposition = $1,200,000 | |
| • Capital Cost = $950,000 | ( 950,000) |
| Negative Ending Balance = Recapture Of CCA | ($159,258) |

## Part A - Down Payment = 10 Percent

### *2019 Results*

The $159,258 of recapture must be included in income in this year.

With a down payment of $150,000 [(10%)($1,500,000)], interest must be accrued on the outstanding balance of $1,350,000 ($1,500,000 - $150,000). At 6 percent, the amount would be $81,000.

With respect to the capital gains, under ITA 40(1)(a)(iii), the amount that can be deducted as a capital gains reserve is equal to the lesser of:

- [(Capital Gain)(Proceeds Not Yet Due ÷ Total Proceeds)]
- [(Capital Gain)(20%)(4 - Number Of Preceding Years Ending After Disposition)]

While the gains on the land and building must be calculated separately, there is no reason to separate them for the purposes of determining the available reserve. This is based on the fact that, in the absence of some reason to apply it differently, the 10 percent down payment would apply equally to each component of the sale.

With a down payment of $150,000, the available reserve would be the lesser of:

- [($300,000)($1,350,000 ÷ $1,500,000)] = $270,000
- [($300,000)(20%)(4 - 0)] = $240,000

Using the lesser figure of $240,000, the taxable capital gain to be included in Net Income For Tax Purposes would be $30,000 [(1/2)($300,000 - $240,000). The total inclusion in Net Income For Tax Purposes for 2019 would be as follows:

| | |
|---|---|
| Recapture | $159,258 |
| Interest | 81,000 |
| Taxable Capital Gain | 30,000 |
| Total For 2019 | $270,258 |

### *2020 Results*

For this year, the reserve would be the lesser of:

- [($300,000)($1,350,000 ÷ $1,500,000)] = $270,000
- [($300,000)(20%)(4 - 1)] = $180,000

Based on this, the total inclusion in Net Income For Tax Purposes for 2020 would be as follows:

| | |
|---|---|
| 2019 Reserve Added To Income | $240,000 |
| 2020 Reserve | ( 180,000) |
| Net Capital Gain | $ 60,000 |
| Inclusion Rate | 1/2 |
| Net Taxable Capital Gain | $ 30,000 |
| Interest (Same As 2019) | 81,000 |
| Total For 2020 | $111,000 |

***2021 Results***

For this year, the reserve would be the lesser of:

- [($300,000)(Nil ÷ $1,500,000)] = Nil
- [($300,000)(20%)(4 - 2)] = $120,000

Based on this, the total inclusion in Net Income For Tax Purposes for 2021 would be as follows:

| | |
|---|---|
| 2020 Reserve Added To Income | $180,000 |
| 2021 Reserve | Nil |
| Net Capital Gain | $180,000 |
| Inclusion Rate | 1/2 |
| Net Taxable Capital Gain | $ 90,000 |
| Interest | Nil |
| Total For 2021 | $ 90,000 |

## Part B - Down Payment = 30 Percent

***2019 Results***

While the down payment is changed in this case, the amount of recapture would be the same as in Part A. However, the interest would be reduced to $63,000 [(6%)($1,500,000 - $450,000)].

With the down payment of $450,000 [(30%)($1,500,000)], the available reserve would be the lesser of:

- [($300,000)($1,050,000 ÷ $1,500,000)] = $210,000
- [($300,000)(20%)(4 - 0)] = $240,000

Using the lesser figure of $210,000, the taxable capital gain to be included in Net Income For Tax Purposes would be $45,000 [(1/2)($300,000 - $210,000)].

The total inclusion in Net Income For Tax Purposes for 2019 would be as follows:

| | |
|---|---|
| Recapture | $159,258 |
| Interest | 63,000 |
| Taxable Capital Gain | 45,000 |
| Total For 2019 | $267,258 |

***2020 Results***

For this year, the reserve would be the lesser of:

- [($300,000)($1,050,000 ÷ $1,500,000)] = $210,000
- [($300,000)(20%)(4 - 1)] = $180,000

Based on this, the total inclusion in Net Income For Tax Purposes for 2020 would be as follows:

| | |
|---|---|
| 2019 Reserve Added To Income | $210,000 |
| 2020 Reserve | ( 180,000) |
| Net Capital Gain | $ 30,000 |
| Inclusion Rate | 1/2 |
| Net Taxable Capital Gain | $ 15,000 |
| Interest (Same As 2019) | 63,000 |
| Total For 2020 | $ 78,000 |

***2021 Results***

For this year, the results are the same as in Part A. The reserve would be the lesser of:

- [($300,000)(Nil ÷ $1,500,000)] = Nil
- [($300,000)(20%)(4 - 2)] = $120,000

Based on this, the total inclusion in Net Income For Tax Purposes for 2021 would be as follows:

| | |
|---|---|
| 2020 Reserve Added To Income | $180,000 |
| 2021 Reserve | Nil |
| Net Capital Gain | $180,000 |
| Inclusion Rate | 1/2 |
| Net Taxable Capital Gain | $ 90,000 |
| Interest | Nil |
| Total For 2021 | $ 90,000 |

## Self Study Solution Eight - 5

For 2018, Mrs. Simpkins would have a capital gain of $10,000 ($25,000 - $15,000), of which one-half is taxable, resulting in a taxable capital gain of $5,000. While this could have been reduced through the use of reserves, Mrs. Simpkins chose not to do so.

In 2019, the inability to collect the note payment would result in a capital loss of $10,000 (Nil - $10,000). The $5,000 allowable amount of this loss must first be applied against any taxable capital gains that are realized in 2019. If such gains are not sufficient to absorb the loss, all or part of the $5,000 can be carried back and applied against the taxable capital gain that was recognized in 2018 (assuming there were no 2018 allowable capital losses net against it).

Any loss that is not carried back can be carried forward indefinitely and applied against future capital gains. (Loss carry overs are covered in Chapter 11.)

## Self Study Solution Eight - 6

***Capital Gains Reserve***

With respect to the capital gains, under ITA 40(1)(a)(iii), the amount that can be deducted as a capital gains reserve is equal to the lesser of:

- [(Capital Gain)(Proceeds Not Yet Due ÷ Total Proceeds)]
- [(Capital Gain)(20%)(4 - Number Of Preceding Years Ending After Disposition)]

***2019 Results***

The only tax consequence in this year is the capital gain that occurs on the sale. The gain, along with the maximum deductible reserve, would be calculated as follows:

| | |
|---|---|
| Proceeds Of Disposition | $6,680,000 |
| Adjusted Cost Base | ( 2,160,000) |
| Capital Gain | $4,520,000 |
| Reserve - Lesser Of: | |
| • [($4,520,000)($4,500,000 ÷ $6,680,000)] = $3,044,910 | |
| • [($4,520,000)(20%)(4 - 0)] = $3,616,000 | ( 3,044,910) |
| Capital Gain | $1,475,090 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain | $ 737,545 |

As no provision can be made for the estimated cost of the warranty, the total Net Income For Tax Purposes inclusion for 2019 would be $737,545.

### *2020 Results*

For this year, the reserve would be the lesser of:

- [($4,520,000)($3,000,000 ÷ $6,680,000)] = $2,029,940
- [($4,520,000)(20%)(4 - 1)] = $2,712,000

Based on this, the total inclusion in Net Income For Tax Purposes for 2020 would be as follows:

| | |
|---|---|
| 2019 Reserve Added To Income | $3,044,910 |
| 2020 Reserve | ( 2,029,940) |
| Capital Gain | $1,014,970 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain | $ 507,485 |
| Interest [(4%)($4,500,000)] | 180,000 |
| Total | $ 687,485 |

### *2021 Results*

For this year, the reserve would be the lesser of:

- [($4,520,000)($1,500,000 ÷ $6,680,000)] = $1,014,970
- [($4,520,000)(20%)(4 - 2)] = $1,808,000

He will have a capital gain consisting of the addition of the 2020 reserve in income and the deduction of a new reserve for 2021. He will also have a capital loss due to the $1,000,000 payment to the developer. As this payment is required by a warranty on a capital asset, it is a capital loss.

Based on this, the total inclusion in Net Income For Tax Purposes for 2021 would be as follows:

| | |
|---|---|
| 2020 Reserve Added To Income | $2,029,940 |
| 2021 Reserve | ( 1,014,970) |
| Capital Gain | $1,014,970 |
| Capital Loss On Warranty Payment On Capital Asset | ( 1,000,000) |
| Net Capital Gain | $ 14,970 |
| Inclusion Rate | 1/2 |
| Net Taxable Capital Gain | $ 7,485 |
| Interest [(4%)($3,000,000)] | 120,000 |
| Total | $ 127,485 |

### *2022 Results*

With the bankruptcy of the developer, no interest will be collected in 2022 and the balance of the loan must be written off as a bad debt, resulting in a capital loss of $1,500,000 [(Nil - ($4,500,000 - $3,000,000)].

Lawrence will include the 2021 reserve of $1,014,970 in income. Since the loan was to be paid off in 2022, there would have been no new reserve to be deducted, regardless of the bankruptcy.

The capital loss can be deducted to the extent of the capital gain of $1,014,970. The remaining allowable capital loss of $242,515 [(1/2)($1,500,000 - $1,014,970)] can only be deducted in 2022 to the extent of taxable capital gains in that year. However, it can be carried back to be applied to the capital gains that were recognized in previous years.

### *Summary (Not Required)*

The results can be summarized as follows:

| Year | Interest | Net Taxable Gain (Allowable Loss) |
|---|---|---|
| 2019 | Nil | $737,545 |
| 2020 | $180,000 | 507,485 |
| 2021 | 120,000 | 7,485 |
| 2022 | Nil | ( 242,515) |
| Totals | $300,000 | $1,010,000 |

The amount of the taxable capital gain can be verified as follows:

| | |
|---|---|
| Initial Capital Gain | $4,520,000 |
| Warranty Payment | ( 1,000,000) |
| Bad Debt | ( 1,500,000) |
| Capital Gain | $2,020,000 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain | $1,010,000 |

## Self Study Solution Eight - 7

The gains on the two properties can be calculated as follows:

| | Country Home | Condominium |
|---|---|---|
| Proceeds Of Disposition | $1,200,000 | $900,000 |
| Adjusted Cost Base | ( 850,000) | ( 625,000) |
| Real Estate Commissions | | |
| [(5%)($1,200,000)] | ( 60,000) | |
| [(5%)($900,000)] | | ( 45,000) |
| Total Capital Gain | $ 290,000 | $230,000 |

The annual gain was $18,125 ($290,000 ÷ 16) on the country home and $28,750 ($230,000 ÷ 8) on the condominium. This would indicate that the maximum number of years should be allocated to the condominium. However, because of the plus 1 in the reduction formula, one year can be left off.

Based on this analysis, the seven years 2013 through 2019 should allocated to the condominium, with the nine years 2004 through 2012 being allocated to the country home. The required calculations would be as follows:

| | Country Home | Condominium |
|---|---|---|
| Total Capital Gain | $ 290,000 | $230,000 |
| Exemption: | | |
| Country Home | | |
| [$290,000][(9 + 1) ÷ 16] | ( 181,250) | |
| Condominium | | |
| [$230,000][(7 + 1) ÷ 8] | | ( 230,000) |
| Capital Gain | $108,750 | Nil |
| Inclusion Rate | 1/2 | N/A |
| Taxable Capital Gain | $ 54,375 | Nil |

This gives a total taxable capital gain on the two properties of $54,375.

## Self Study Solution Eight - 8

### *Classification Of Property*

All of the items sold are personal use property. However, if they can be classified as "listed personal property", their tax treatment will be different. Under ITA 54, listed personal property consists of the following items.

- (i) print, etching, drawing, painting, sculpture, or other similar work of art,
- (ii) jewelry,
- (iii) rare folio, rare manuscript, or rare book,
- (iv) stamp, or
- (v) coin.

The Paul Borduas painting, as well as the Hemingway first edition clearly fall into the listed personal property classification. The Bentley and the Chris Craft clearly do not.

The classification of the fountain pen collection is not clear. The issue is whether a pen can be considered jewelry (and not a writing implement) as there are fountain pens that cost as much as $100,000 and are made from precious metals and stones.

The dictionary definition of jewel includes "a precious possession". However, the definition of jewelry is more narrow, referring to "ornaments for personal adornment". Whether something that is displayed on one's desk would be considered personal adornment would be debatable, but the fact that Mr. Howard always "wears" the pens prominently would favour the jewelry classification.

In the solution which follows, we have classified the pens as jewelry. However, we recognize that this classification could be subject to challenge.

### *Effect On Net Income For Tax Purposes*

The overall amount to be included in Net Income For Tax Purposes can be calculated as follows:

| | | |
|---|---|---|
| **Personal Use Property (Note 1)** | | |
| Gain On Antique Boat ($62,000 - $45,000) | $17,000 | |
| Loss On Bentley | Nil | $17,000 |
| **Listed Personal Property** | | |
| Gain On First Edition ($31,000 - $12,000) | $19,000 | |
| Gain On Painting ($132,000 - $128,000) | 4,000 | |
| Total Listed Personal Property Gains | $23,000 | |
| Loss On Pens (Note 2) | ( 23,000) | Nil |
| Net Capital Gains | | $17,000 |
| Inclusion Rate | | 1/2 |
| Addition To Net Income For Tax Purposes | | $ 8,500 |

**Note 1** Unless an item of personal use property can be classified as listed personal property, losses on its disposition cannot be deducted. However, gains on such property are taxable, without regard to the classification.

**Note 2** The total loss on the pen collection is $29,000 ($13,000 - $42,000). However, the current year deduction is limited to the $23,000 in gains on listed personal property. The remaining $6,000 ($29,000 - $23,000) can be carried back 3 years and forward 7 years to be applied against gains on listed personal property that have occurred in previous years or may occur in subsequent years.

## Self Study Solution Eight - 9

The taxable capital gain on the sale of securities would be calculated as follows:

| | |
|---|---|
| Proceeds Of Disposition [(3,500)(€33.50)($1.49)] | $174,703 |
| Adjusted Cost Base [(3,500)(€30.00)($1.46)] | ( 153,300) |
| Capital Gain On Sale Of Securities | $ 21,403 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain | $ 10,702 |

The taxable capital gain on the foreign exchange conversion would be calculated as follows:

| | |
|---|---|
| Proceeds Of Conversion [(€117,250)($1.52)] | $178,220 |
| Adjusted Cost Base Of Currency [(€117,250)($1.49)] | ( 174,703) |
| Capital Gain On Foreign Exchange | $ 3,517 |
| ITA 39(1.1) Reduction Of Capital Gain | ( 200) |
| Net Capital Gain | $ 3,317 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain | $ 1,659 |

Ms. Laval's minimum Net Income For Tax Purposes inclusion would be a total taxable capital gain of $12,361 ($10,702 + $1,659).

Because Ms. Laval is an individual, the ITA 39(1.1) deduction of $200 reduces the capital gain on the foreign exchange conversion.

## Self Study Solution Eight - 10

### 2017 Results

During 2017, 100 percent of the property was used for income producing purposes. The CCA for the year would be calculated as follows:

| | |
|---|---|
| Capital Cost ($645,000 - $120,000) | $525,000 |
| One-Half Net Additions | ( 262,500) |
| CCA Base | $262,500 |
| Maximum CCA [(4%)($262,500)] | ( 10,500) |
| One-Half Net Additions | 262,500 |
| UCC - January 1, 2018 | $514,500 |

There are no additional tax consequences during this year.

### 2018 Results

On January 1, 2018, there would be a deemed disposition/acquisition of 25 percent of the depreciable property. The transaction would be measured using the building's fair market value of $460,000 ($560,000 - $100,000). Given this, the maximum CCA on the remaining 75 percent would be calculated as follows:

| | |
|---|---|
| Opening UCC | $514,500 |
| Deemed Disposition - Lesser Of: | |
| • Capital Cost [(25%)($525,000)] = $131,250 | |
| • Deemed Proceeds [(25%)($460,000)] = $115,000 | ( 115,000) |
| CCA Base | $399,500 |
| Maximum CCA [(4%)($399,500)] | ( 15,980) |
| UCC - January 1, 2019 | $383,520 |

While the value of the building has declined from $525,000 ($645,000 - $120,000) to $460,000 ($560,000 - $100,000), no loss can be recognized. As there is still an asset in the Class, a terminal loss cannot be recognized. In addition, we would remind you that you cannot have a capital loss on a depreciable asset disposition.

The allowable capital loss on the land of $2,500 [(25%)(1/2)($120,000 - $100,000)] can be deducted against the taxable capital gains on dispositions from her portfolio. Since her income from other sources is so high, she will deduct maximum CCA regardless of how the business is doing.

The cost to Laci of the 25 percent of the property that is being used for personal purposes would be $115,000 [(25%)($460,000)] allocated to the building and $25,000 [(25%)($100,000)] allocated to the land.

### 2019 Results

On January 1, 2019, there would be a deemed acquisition of 25 percent of the depreciable property. The capital cost of the building acquisition would be $140,000 [(25%)($690,000 - $130,000)]. However, as the change is from personal use to business use and the fair market value of the building is greater than its cost, the UCC will be limited to her cost plus one-half of the difference between fair market value and cost or $127,500 [$115,000 + (1/2)($140,000 - $115,000)].

Maximum CCA for would be calculated as follows:

| | |
|---|---|
| Opening UCC | $383,520 |
| Deemed Acquisition<br>[$115,000 + (1/2)($140,000 - $115,000)] | 127,500 |
| One-Half Net Additions [(1/2)($127,500)] | ( 63,750) |
| CCA Base | $447,270 |
| Maximum CCA [(4%)($447,270)] | ( 17,891) |
| One-Half Net Additions | 63,750 |
| UCC - January 1, 2020 | $493,129 |

As a result of the deemed disposition, Laci would have a taxable capital gain on both the land and the building. They would be calculated as follows:

| | Land | Building |
|---|---|---|
| Proceeds Of Disposition | | |
| [(25%)($130,000)] | $32,500 | |
| [(25%)($560,000)] | | $140,000 |
| Adjusted Cost Base [(25%)($100,000)] | ( 25,000) | |
| Capital Cost [(25%)($460,000)] | | ( 115,000) |
| Capital Gains | $ 7,500 | $ 25,000 |
| Inclusion Rate | 1/2 | 1/2 |
| Taxable Capital Gains | $ 3,750 | $ 12,500 |

Even though Laci has a home other than the apartment, she could eliminate these gains by making use of the +1 year in the principal residence exemption formula. Assuming she did that, she would have to allow for the designated year in the exemption formula when she sells her home.

## Self Study Solution Eight - 11

### *2017 Results*

During 2017, 80 percent of the property is used for income producing purposes. Based on this the maximum CCA that can be deducted for this year is calculated as follows:

| | |
|---|---|
| Capital Cost [(80%)($500,000)] | $400,000 |
| One-Half Net Additions | ( 200,000) |
| CCA Base | $200,000 |
| Maximum CCA [(4%)($200,000)] | ( 8,000) |
| One-Half Net Additions | 200,000 |
| UCC - January 1, 2018 | $392,000 |

There are no additional tax consequences during this year.

### *2018 Results - Business To Personal Use*

On January 1, 2018, there would be a deemed disposition/acquisition of 20 percent of the total property. This would result in a taxable capital gain on the land calculated as follows:

| | |
|---|---|
| Proceeds Of Disposition [(20%)($230,000)] | $46,000 |
| Adjusted Cost Base [(20%)($225,000)] | ( 45,000) |
| Capital Gain | $ 1,000 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain On Land | $ 500 |

There would also be taxable capital gain on the building, calculated as follows:

| | |
|---|---|
| Proceeds Of Disposition [(20%)($585,000) | $117,000 |
| Adjusted Cost Base [(20%)($500,000)] | ( 100,000) |
| Capital Gain | $ 17,000 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain | $ 8,500 |

The maximum CCA for 2018 would be calculated as follows:

| | |
|---|---|
| Opening UCC | $392,000 |
| Disposition: Lesser Of: | |
| Capital Cost [(20%)($500,000)] = $100,000 | |
| Proceeds Of Disposition | |
| [(20%)($585,000) = $117,000 | ( 100,000) |
| CCA Base | $292,000 |
| Maximum CCA [(4%)($292,000)] | ( 11,680) |
| UCC - January 1, 2019 | $280,320 |

***2019 Results - Personal To Business Use***

On January 1, 2019, there would be a deemed disposition/acquisition of 40 percent of the total property. This would result in a taxable capital gain on the land, calculated as follows:

| | | |
|---|---|---|
| Proceeds Of Disposition [(40%)($245,000)] | | $98,000 |
| Adjusted Cost Base: | | |
| [(20%)($225,000)] | ($45,000) | |
| [(20%)($230,000)] | ( 46,000) | ( 91,000) |
| Capital Gain | | $ 7,000 |
| Inclusion Rate | | 1/2 |
| Taxable Capital Gain On Land | | $ 3,500 |

There would also be a taxable capital gain on the building, calculated as follows:

| | | |
|---|---|---|
| Proceeds Of Disposition [(40%)($630,000)] | | $252,000 |
| Adjusted Cost Base: | | |
| [(20%)($500,000)] | ($100,000) | |
| [(20%)($585,000)] | ( 117,000) | ( 217,000) |
| Capital Gain | | $ 35,000 |
| Inclusion Rate | | 1/2 |
| Taxable Capital Gain | | $ 17,500 |

With respect to maximum CCA, this change in use involves a deemed disposition/acquisition from personal use to business use. In addition, the fair market value of the building is greater than her cost. Given this, the UCC will be limited to her cost plus one-half of the difference between fair market value and cost. This amount would be $17,500, as calculated in the preceding table as the taxable capital gain.

Maximum CCA for would be calculated as follows:

| | | |
|---|---|---|
| Opening UCC | | $280,320 |
| Deemed Acquisition Cost | | |
| [(20%)($500,000)] | $100,000 | |
| [(20%)($585,000)] | 117,000 | |
| Bump Up | 17,500 | 234,500 |
| One-Half Net Additions [(1/2)($234,500)] | | ( 117,250) |
| CCA Base | | $397,570 |
| Maximum CCA [(4%)($397,570)] | | ( 15,903) |
| One-Half Net Additions | | 117,250 |
| UCC - January 1, 2020 | | $489,537 |

***Note To Students***

In the Required we have asked you to ignore the principal residence exemption as the focus of the problem is on change in use. The textbook states that if there is non-residential use of a principal residence, the CRA will not apply the partial disposition rules so long as the income use is ancillary to the main use as a principal residence, there is no structural change to the property, and no CCA is claimed.

CCA was claimed on the 20 percent that went from business to principal residence back to business and the textbook does not specifically cover the effect of this CCA issue or a property where the principal residence portion is originally a small percentage of the total, on the principal residence exemption.

The fact that the business had claimed CCA on the 20 percent portion that was subsequently added to the personal portion when the business use dropped from 80 percent to 60 percent would not cause any adjustment to the principal residence. From a tax policy point of view, a change from personal use to business use is a concern since the personal use disposition results in capital gains with the added cost potentially being fully deductible as CCA. This is the reason why the change of use rules only allow half the increase in value to be added to cost. This issue does not arise, however when the property is converted from an income use to a personal use.

If the principal residence exemption was considered, when the 40 percent principal residence portion is changed to business use in 2019, that event would cause a disposition of a principal residence which would then be eligible for the principal residence exemption. As a result, there would be no net capital gain for 2019.

## Self Study Solution Eight - 12

Mr. Lange's taxable capital gain on deemed dispositions resulting from his departure from Canada would be calculated as follows:

| | |
|---|---|
| Vacant land | N/A |
| Automobile | N/A |
| Coin Collection ($11,000 - $5,000) | $ 6,000 |
| Enbridge Shares ($38,000 - $24,000) | 14,000 |
| BCE Shares ($35,000 - $42,000) | ( 7,000) |
| Royal Bank Shares ($23,000 - $15,000) | 8,000 |
| Nal Enterprises Ltd. Shares ($153,000 - $26,000) | 127,000 |
| Capital Gain | $148,000 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain On Departure | $ 74,000 |

The vacant land is exempt from the deemed disposition rules that are applicable to individuals leaving Canada. However, as it is taxable Canadian property, a later sale of this land will attract Canadian income taxes, even though Mr. Lange is no longer a Canadian resident.

The loss on the automobile is not deductible as the vehicle is a personal use property.

## Self Study Solution Eight - 13

### *First Sale*

Since Ms. Tosh has held the Tech Ltd. common shares for more than 185 days, it is a qualifying disposition. Since the Small Oil common shares were purchased immediately, they can be designated as replacement shares.

Preferred shares cannot be designated as replacement shares. As a result, the Small Bank Inc. shares do not qualify as replacement shares.

The capital gain on the Tech Ltd. disposition is $700,000 ($4,200,000 - $3,500,000). As the cost of replacement shares is only $3,800,000, the permitted deferral is limited as per the following calculation:

[($700,000)($3,800,000 ÷ $4,200,000)] = $633,333 Deferral

Given this, the adjusted cost base of the Small Oil shares would be calculated as follows:

| | |
|---|---|
| Unadjusted Cost | $3,800,000 |
| Deferral Amount | ( 633,333) |
| Adjusted Cost Base Of Small Oil Shares | $3,166,667 |

### *Second Sale*

Since Ms. Tosh has held the Future Inc. common shares for more than 185 days, it is a qualifying disposition. Since the eligible small business corporation common shares were purchased in the current year, they can be designated as replacement shares.

The capital gain on the disposition of Future Inc. shares is $1,800,000 ($5,600,000 - $3,800,000). Of the $5,600,000 in proceeds, only $5,200,000 ($2,400,000 + $2,800,000) was invested in replacement shares. This means that the permitted deferral will be limited as per the following calculation:

[($1,800,000)($5,200,000 ÷ $5,600,000)] = $1,671,429 Deferral

Using this information, the adjusted cost base of the newly acquired shares would be calculated as follows:

| | Sombra Shares | Ziff Shares |
|---|---|---|
| Purchase Price | $2,400,000 | $2,800,000 |
| Deferral: | | |
| [($1,671,429)($2,400,000 ÷ $5,200,000)] | ( 771,429) | |
| [($1,671,429)($2,800,000 ÷ $5,200,000)] | | ( 900,000) |
| Adjusted Cost Base | $1,628,571 | $1,900,000 |

### *Net Taxable Capital Gain*

If Ms. Tosh does not purchase any other replacements shares within 120 days of December 31, 2019, the two sales would result in a taxable capital gain, calculated as follows:

| | Total Gain | Deferral | Net Gain |
|---|---|---|---|
| Tech Ltd. Shares | $ 700,000 | $ 633,333 | $ 66,667 |
| Future Inc. Shares | 1,800,000 | 1,671,429 | 128,571 |
| Totals | $2,500,000 | $2,304,762 | $195,238 |
| Inclusion Rate | | | 1/2 |
| Net Taxable Capital Gain | | | $ 97,619 |

### Tax Advice

If Ms. Tosh invests in any eligible small business corporation common shares, including her brother's company's, within 120 days of December 31, 2019, she can designate up to $800,000 as replacement shares. She would then be able to defer more or all of the capital gain on the two sales of shares.

If she wants to invest in her brother's company after the 120 days has passed, she should review her other investments to determine if she can use the deferral provisions on small business investments to her advantage to obtain the $1,000,000.

There is the question of whether Ms. Tosh should invest in her brother's new company, but that would involve an analysis that goes beyond the scope of the material in the text.

## Self Study Solution Eight - 14

### 2019 Results

The insurance proceeds would create recaptured CCA, calculated as follows:

| | |
|---|---|
| Opening UCC Balance | $ 368,000 |
| Disposition - Lesser Of: | |
| • Cost = $500,000 | |
| • Proceeds Of Disposition = $490,000 | ( 490,000) |
| Negative Closing Balance = Recapture | ($ 122,000) |
| Recapture | 122,000 |
| January 1, 2020 UCC | Nil |

The $122,000 in recapture would be taken into 2019 income and added back to the UCC to create a UCC balance of nil.

### 2020 Results

Using ITA 13(4), Trail Resources Ltd. would file an amended return for the 2019 taxation year. The revised recapture would be calculated as follows:

| | | |
|---|---|---|
| January 1, 2019 UCC Balance | | $368,000 |
| Deduction: | | |
| Lesser Of: | | |
| • Proceeds Of Disposition = $490,000 | | |
| • Capital Cost = $500,000 | $490,000 | |
| Reduced By The Lesser Of: | | |
| • Normal Recapture = $122,000 | | |
| • Replacement Cost = $650,000 | ( 122,000) | ( 368,000) |
| Recapture Of 2019 CCA (Amended) | | Nil |

The new nil figure for the recapture on the disposition of the old building will replace the old figure of $122,000 that was included in the original 2019 return.

The UCC of the new building will be adjusted for this change as follows:

| | |
|---|---|
| Cost Of New Building | $ 650,000 |
| Reversal Of Recapture - ITA 13(4) Election | ( 122,000) |
| UCC | $ 528,000 |

Given this, the required maximum CCA for 2020 and the January 1, 2021 UCC balance would be calculated as follows:

| | |
|---|---|
| Opening UCC - Class 1 | Nil |
| Addition Of UCC Of New Building | $528,000 |
| AccII Adjustment | 264,000 |
| Base For CCA | $792,000 |
| Maximum CCA [($792,000)(6%)] | ( 47,520) |
| AccII Adjustment Reversal | ( 264,000) |
| January 1, 2021 UCC | $480,480 |

The reasonableness of the CCA base calculation can be verified by noting that the $528,000 is equal to the initial UCC of $368,000, plus the cost of the new building of $650,000, less the insurance proceeds of $490,000. The AccII provisions are applied to the addition to Class 1.

## Self Study Solution Eight - 15

### *Part A*

The 2019 tax consequences would be as follows:

**Land** The Company would have a taxable capital gain on the Land calculated as follows:

| | |
|---|---|
| Proceeds Of Disposition | $1,100,000 |
| Adjusted Cost Base | ( 350,000) |
| Capital Gain | $ 750,000 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain | $ 375,000 |

**Building** The Company would have a taxable capital gain and recapture calculated as follows:

| | |
|---|---|
| Proceeds Of Disposition | $2,300,000 |
| Capital Cost | ( 2,100,000) |
| Capital Gain | $ 200,000 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain | $ 100,000 |

| | |
|---|---|
| Opening UCC | $ 850,000 |
| Deduct Disposition - Lesser Of: | |
| Capital Cost = $2,100,000 | |
| Proceeds Of Disposition = $2,300,000 | ( 2,100,000) |
| Negative Closing UCC Balance = Recapture | ($1,250,000) |
| Recapture (Included In Income) | 1,250,000 |
| UCC - January 1, 2020 | Nil |

**Equipment** The Company would have recapture calculated as follows:

| | |
|---|---|
| Opening UCC | $165,000 |
| Deduct Disposition - Lesser Of: | |
| Capital Cost = $450,000 | |
| Proceeds Of Disposition = $320,000 | ( 320,000) |
| Negative Closing UCC Balance = Recapture | ($155,000) |
| Recapture (Included In Income) | 155,000 |
| UCC - January 1, 2020 | Nil |

***Part B***

**Land** With respect to the Land, the capital gain resulting from the use of the ITA 44(1) election would be the lesser of:

- $750,000 (regular capital gain); and
- $500,000 (the excess of the $1,100,000 proceeds of disposition for the old land over the $600,000 cost of the replacement land).

The taxable amount would be $250,000 [(1/2)($500,000)] and this would be included in the revised 2019 Net Income For Tax Purposes. The original gain of $375,000 would be eliminated in the revised return.

If the ITA 44(1) election is used in 2020, the deemed adjusted cost base of the replacement land would be calculated as follows:

| | |
|---|---|
| Actual Cost | $600,000 |
| Capital Gain Reversed By Election ($750,000 - $500,000) | ( 250,000) |
| Deemed Adjusted Cost Base Of Replacement Land | $350,000 |

Note that the deemed adjusted cost base of the replacement land has been reduced to the adjusted cost base of the old land.

**Building** If the ITA 44(1) election is used in 2020, the amended 2019 capital gain would be nil, the lesser of:

- $200,000 (regular capital gain); and
- Nil (reflecting the fact that there was no excess of the $2,300,000 proceeds of disposition for the old building over the $2,500,000 cost of the replacement building).

Using this election will reduce the deemed capital cost for the building as follows:

| | |
|---|---|
| Actual Cost | $2,500,000 |
| Capital Gain Reversed By Election | ( 200,000) |
| Deemed Capital Cost Of Replacement Building | $2,300,000 |

If the ITA 13(4) election is used in 2020, the amended 2019 recapture would be calculated as follows:

| | | |
|---|---|---|
| January 1, 2019 UCC Balance | | $850,000 |
| Deduction: | | |
| Lesser Of: | | |
| • Proceeds Of Disposition = $2,300,000 | | |
| • Capital Cost = $2,100,000 | ($2,100,000) | |
| Reduced By The Lesser Of: | | |
| • Normal Recapture = $1,250,000 | | |
| • Replacement Cost = $2,500,000 | 1,250,000 | ( 850,000) |
| Recapture Of 2019 CCA (Amended) | | Nil |

If both elections are used in 2020, the UCC of the replacement building is calculated as follows:

| | |
|---|---|
| Deemed Capital Cost | $2,300,000 |
| Recapture Reversed By Election | ( 1,250,000) |
| UCC - Replacement Building | $1,050,000 |

Note that the $1,050,000 UCC for the new building is equal to the UCC of the old building ($850,000), plus the additional $200,000 ($2,500,000 - $2,300,000) in funds required for its acquisition.

These new nil figures for the capital gain and the recapture on the disposition of the old building will replace the old figures of $100,000 and $1,250,000 that were included in the original 2019 return.

**Equipment** As this is a voluntary disposition, the ITA 13(4) and 44(1) elections can only be used on real property (land and buildings). They cannot be used on the equipment and, as a consequence, the $155,000 in recapture will not be altered in the amended return. As the elections cannot be used, both the capital cost and the UCC of the new equipment will be $520,000.

***Part C***

**The Election** The ITA 44(6) election applies when there is a disposition involving a combination of part land and part building. If, for either of the assets, the proceeds of disposition exceed the adjusted cost base, the election allows the transfer of all or part of that excess to the other asset.

As will be demonstrated in this problem, this can provide some relief when ITA 44(1) and ITA 13(4) fail to eliminate all of the capital gains arising on one part of the disposition of the old property. ITA 44(1) fully eliminated the capital gain on the building. However, a $500,000 capital gain remained on the land. This would suggest that it could be advantageous to transfer some of the proceeds of disposition from the land to the building.

The excess of the proceeds of disposition of the old land over the cost of the replacement land was $500,000 ($1,100,000 - $600,000). This is the maximum available transfer from the land to the building. However, the excess of the cost of the replacement building over the old building's proceeds of disposition is only $200,000 ($2,500,000 - $2,300,000). If a transfer in excess of this amount is made, any reduction in the capital gain on the land will be matched by an increased capital gain on the building.

Applying ITA 44(6) in an optimal manner will result in the following adjusted proceeds of disposition:

| | Land | Building |
|---|---|---|
| Actual Proceeds Of Disposition | $1,100,000 | $2,300,000 |
| Optimal Transfer Land To Building | ( 200,000) | 200,000 |
| Adjusted Proceeds Of Disposition | $ 900,000 | $2,500,000 |

**Application To Land** If both ITA 44(1) and ITA 44(6) are applied, the resulting capital gain on the land will be calculated as the lesser of:

- $550,000 ($900,000 - $350,000); and
- $300,000 (the excess of the $900,000 adjusted proceeds of disposition for the old land over the $600,000 cost of the replacement land).

This is a reduction of $200,000 ($500,000 - $300,000) from the amount that was calculated when only ITA 44(1) was applied. However, the adjusted cost base of the land would be unchanged by the use of ITA 44(6):

| | |
|---|---|
| Actual Cost | $600,000 |
| Capital Gain Reversed By Election ($550,000 - $300,000) | ( 250,000) |
| Deemed Adjusted Cost Base Of Replacement Land | $350,000 |

**Application To Building** With the proceeds of disposition transfer limited to $200,000, the capital gain on the building is still nil. Specifically, the gain will be the lesser of:

- $400,000 ($2,500,000 - $2,100,000); and
- Nil (reflecting the fact that there was no excess of the $2,500,000 adjusted proceeds of disposition for the old building over the $2,500,000 cost of the replacement building).

However, the capital cost and UCC of the building will be reduced by the application of ITA 44(6):

| | |
|---|---|
| Actual Cost | $2,500,000 |
| Capital Gain Reversed By The Two Elections | ( 400,000) |
| Deemed Capital Cost | $2,100,000 |
| Recapture Reversed By Election | ( 1,250,000) |
| UCC - Replacement Building | $ 850,000 |

Note that the UCC for the new building is equal to the UCC of the old building.

**Comparison** The table which follows compares the results of using only ITA 44(1) and ITA 13(4) with the results that arise when the ITA 44(6) election is also used.

| | **No ITA 44(6)** | **With ITA 44(6)** |
|---|---|---|
| Capital Gains | | |
| Land | $500,000 | $300,000 |
| Building | Nil | Nil |
| Replacement Property | | |
| Adjusted Cost Base Of Land | $ 350,000 | $ 350,000 |
| Capital Cost Of Building | 2,300,000 | 2,100,000 |
| UCC | 1,050,000 | 850,000 |

As you can see in the table, the use of ITA 44(6) has reduced the capital gain on the land by $200,000. However, it has done so at the cost of reducing the capital cost and UCC of the replacement building. There is a tax cost associated with this trade off in that only one-half of the capital gain would have been taxed in the current year, whereas the future CCA that has been lost would be fully deductible.

## Self Study Solution Eight - 16

### *Part A*

The proceeds of disposition were greater than the relevant capital costs for all the destroyed and expropriated assets. As a result, with respect to Net Income For Tax Purposes, the 2019 tax effects related to the involuntary dispositions would be as follows:

| | **Old Land** | **Old Building** | **Old Contents** |
|---|---|---|---|
| Proceeds Of Disposition | $723,000 | $4,800,000 | $1,256,000 |
| Adjusted Cost Base/Capital Cost | ( 256,000) | ( 3,700,000) | ( 972,000) |
| Capital Gains | $467,000 | $1,100,000 | $ 284,000 |
| Inclusion Rate | 1/2 | 1/2 | 1/2 |
| Taxable Capital Gains | $233,500 | $ 550,000 | $ 142,000 |

| | | |
|---|---|---|
| Opening UCC | $1,856,000 | $ 72,000 |
| Capital Cost (Less Than Proceeds) | ( 3,700,000) | ( 972,000) |
| Closing UCC | ($1,844,000) | ($900,000) |
| Recapture Of CCA | 1,844,000 | 900,000 |
| UCC - January 1, 2020 | Nil | Nil |

The increase in Net Income For Tax Purposes totals $3,669,500 ($233,500 + $550,000 + $142,000 + $1,844,000 + $900,000).

### Part B - Land

As the land, building and contents were replaced before the end of the second taxation year following the involuntary dispositions, Fraser can use both ITA 44(1) and ITA 13(4) to modify these results. These changes will be implemented through an amended return.

With respect to the land, the capital gain resulting from the use of the ITA 44(1) election would be the lesser of:

- $467,000 (regular capital gain); and
- $223,000 (the excess of the $723,000 proceeds of disposition for the old land over the $500,000 cost of the new land).

The taxable amount of this capital gain will be $111,500 [(1/2)($223,000)]. The original gain of $467,000 would be eliminated in the revised return.

### Part B - Building

With respect to the building, the capital gain resulting from the use of the ITA 44(1) election would be nil, the lesser of:

- $1,100,000 (regular capital gain); and
- Nil (reflecting the fact that there was no excess of the $4,800,000 proceeds of disposition for the old building over the $5,700,000 cost of the replacement building).

Under ITA 13(4), the revised recapture would be calculated as follows:

| | | |
|---|---|---|
| January 1, 2019 UCC Balance | | $1,856,000 |
| Deduction: | | |
| Lesser Of: | | |
| • Proceeds Of Disposition = $4,800,000 | | |
| • Capital Cost = $3,700,000 | ($3,700,000) | |
| Reduced By The Lesser Of: | | |
| • Normal Recapture = $1,844,000 | | |
| • Replacement Cost = $5,700,000 | 1,844,000 | ( 1,856,000) |
| Recapture Of 2019 CCA (Amended) | | Nil |

These new nil figures for the capital gain and recapture on the building disposition will replace the old figures of $1,100,000 and $1,844,000 that were included in the original 2019 return.

### Part B - Building Contents

If this was a voluntary disposition, the building contents would not be "former business property" and would not qualify for either the ITA 13(4) election or the ITA 44(1) election. However, as this is an involuntary disposition, both elections are available.

Under ITA 44(1), the revised capital gain would be $23,000, the lesser of:

- $284,000 (regular capital gain); and
- $23,000 (the excess of the $1,256,000 proceeds of disposition for the old building contents over the $1,233,000 cost of the replacement contents)

The taxable amount of the gain will be $11,500 [(1/2)($23,000)].

Under ITA 13(4), the revised recapture would be reduced from $900,000 to nil. The calculation is as follows:

| | | |
|---|---|---|
| January 1, 2019 UCC Balance | | $ 72,000 |
| Deduction: | | |
| Lesser Of: | | |
| • Proceeds Of Disposition = $1,256,000 | | |
| • Capital Cost = $972,000 | ($972,000) | |
| Reduced By The Lesser Of: | | |
| • Normal Recapture = $900,000 | | |
| • Replacement Cost = $1,233,000 | 900,000 | ( 72,000) |
| Recapture Of 2019 CCA (Amended) | | Nil |

These new figures for the capital gain and recapture on the contents disposition will replace the old figures of $284,000 and $900,000 that were included in the original 2019 return.

### Comparison - Part A and Part B

As shown in the table which follows, the disposition of the land, building and contents resulted in an increase in 2019 Net Income For Tax Purposes of $3,669,500. When the two elections are used, the amended 2019 return will show a Net Income For Tax Purposes of only $123,000. This is a savings of $3,546,500 ($3,669,500 - $123,000).

| | Part A As Reported | Part B With Elections |
|---|---|---|
| Land - Taxable Capital Gain | $ 233,500 | $111,500 |
| Building - Taxable Capital Gain | 550,000 | Nil |
| Contents - Taxable Capital Gain | 142,000 | 11,500 |
| Building - Recaptured CCA | 1,844,000 | Nil |
| Contents - Recaptured CCA | 900,000 | Nil |
| Total Increase | $3,669,500 | $123,000 |

### Part C

Assuming Fraser decides to use the elections under ITA 44(1) and ITA 13(4), the deemed cost and UCC of the replacement properties would be as follows:

| | Land | Building | Contents |
|---|---|---|---|
| Actual Cost Of Replacement Property | $500,000 | $5,700,000 | $1,233,000 |
| Capital Gain Reversed By Election | | | |
| Land ($467,000 - $223,000) | ( 244,000) | | |
| Building ($1,100,000 - Nil) | | ( 1,100,000) | |
| Contents ($284,000 - $23,000) | | | ( 261,000) |
| Deemed Cost Of Replacement Property | $256,000 | $4,600,000 | $ 972,000 |

| | Building | Contents |
|---|---|---|
| Deemed Capital Cost Of Replacement Property | $4,600,000 | $ 972,000 |
| Recaptured CCA Reversed By Election | | |
| Building ($1,844,000 - Nil) | ( 1,844,000) | |
| Contents ($900,000 - Nil) | | ( 900,000) |
| UCC - Replacement Property | $2,756,000 | $ 72,000 |

The deemed adjusted cost base of the replacement land has been reduced to the adjusted cost base of the old land.

The $4,600,000 deemed capital cost of the replacement building is equal to the $3,700,000 capital cost of the old building, plus the additional $900,000 ($5,700,000 - $4,800,000) in funds paid by Fraser in excess of the insurance proceeds.

In a similar fashion, the UCC for the new building is equal to the UCC of the old building ($1,856,000), plus the additional $900,000 ($5,700,000 - $4,800,000) in funds paid by Fraser in excess of the insurance proceeds.

The deemed capital cost of the new Class 8 assets is equal to the $972,000 capital cost of the old assets.

In a similar fashion, the UCC for the new Class 8 assets is equal to the $72,000 UCC of the old Class 8 assets. Since the $1,233,000 cost of the replacement assets is less than the $1,256,000 in insurance proceeds, there is no increase in the UCC.

### Part D - Optimal Transfer

The ITA 44(6) election applies when there is a disposition involving a combination of part land and part building. If, for either of the assets, the proceeds of disposition exceed the adjusted cost base, the election allows the transfer of all or part of that excess to the other asset.

As will be demonstrated in this problem, this can provide some relief when ITA 44(1) and ITA 13(4) fail to eliminate all of the capital gains arising on one part of the disposition of the old property. ITA 44(1) fully eliminated the capital gain on the building. However, a $223,000 capital gain remained on the land. This would suggest that it could be advantageous to transfer some of the proceeds of disposition from the land to the building.

The excess of the proceeds of disposition of the old land over the cost of the replacement land was $223,000 ($723,000 - $500,000). This is the maximum transfer needed from the land to the building. Since the excess of the cost of the replacement building over the old building's proceeds of disposition is $900,000 ($5,700,000 - $4,800,000), this transfer can be made with creating a capital gain on the building.

Applying ITA 44(6) will result in the following adjusted proceeds of disposition:

| | Land | Building |
|---|---|---|
| Actual Proceeds Of Disposition | $723,000 | $4,800,000 |
| Transfer Needed - Land To Building | ( 223,000) | 223,000 |
| Adjusted Proceeds Of Disposition | $500,000 | $5,023,000 |

### Part D - Application To Land

If both the ITA 44(1) and the ITA 44(6) elections are used, the capital gain on the land will be nil, calculated as the lesser of:

- $244,000 ($500,000 - $256,000); and
- Nil (the excess of the $500,000 adjusted proceeds of disposition for the old land over the $500,000 cost of the new land).

Given this result, the adjusted cost base of the replacement property will be calculated as follows:

| | |
|---|---|
| Actual Cost | $500,000 |
| Capital Gain Reversed By The Two Elections | ( 244,000) |
| Deemed Adjusted Cost Base Of Replacement Land | $256,000 |

Note that this is equal to the adjusted cost base of the old land.

### Part D - Application To The Building

With the proceeds of disposition transfer limited to $223,000, the capital gain on the building is still nil. Specifically, the gain will be the lesser of:

- $1,323,000 ($5,023,000 - $3,700,000); and
- Nil (there is still no excess of the $5,023,000 proceeds of disposition over the replacement cost of $5,700,000).

The deemed capital cost and UCC for the building would be calculated as follows:

| | |
|---|---|
| Actual Cost | $5,700,000 |
| Capital Gain Reversed By The Two Elections | ( 1,323,000) |
| Deemed Capital Cost | $4,377,000 |
| Recapture Reversed By ITA 13(4) | ( 1,844,000) |
| UCC - Replacement Building | $2,533,000 |

### *Part D - Comparison*

The table which follows compares the results of using only ITA 44(1) and ITA 13(4) with the results that arise when the ITA 44(6) election is also used.

| | No ITA 44(6) | With ITA 44(6) | Difference |
|---|---|---|---|
| Capital Gains | | | |
| Land | $223,000 | Nil | ($223,000) |
| Building | Nil | Nil | |
| Replacement Property | | | |
| Adjusted Cost Base Of Land | $ 256,000 | $256,000 | Nil |
| Capital Cost Of Building | 4,600,000 | 4,377,000 | ( 223,000) |
| UCC | 2,756,000 | 2,533,000 | ( 223,000) |

Note that this election is not made without a cost. Had the $223,000 been left as a capital gain, tax would have applied on only one-half of the total. While we have eliminated this $111,500 in income, we have given up future CCA for the full amount of the $223,000. In other words, we have given up $223,000 in future deductions in return for eliminating $111,500 of income in 2019.

## Self Study Solution Eight - 17

### *Employment Income*

Paul's commission income of $62,500 is large enough not to limit the deduction of his employment related expenses. The required calculations would be as follows:

| | |
|---|---|
| Salary | $ 85,000 |
| Additions: | |
| Commissions | 62,500 |
| Stock Option Benefit [(1,500)($19 - $15)] | 6,000 |
| Expense Allowance [(12)($2,500)] | 30,000 |
| Deductions: | |
| RPP Contributions | ( 4,100) |
| Professional Association Dues | ( 1,500) |
| Work Space In The Home Expenses (Note 1) | ( 2,290) |
| Automobile Costs | |
| CCA (Note 2) | ( 6,120) |
| Operating Costs [(80%)($6,100)] | ( 4,880) |
| Hotel Costs | ( 11,500) |
| Airline And Other Transportation | ( 9,200) |
| Client Meals And Entertainment [(1/2)($10,400)] | ( 5,200) |
| Net Employment Income | $138,710 |

**Note 1** As Paul has commission income, he can deduct 20 percent of all of the costs except the mortgage interest. This will provide a deduction of $2,290 [(20%)($3,400 + $7,200 + $850)].

**Note 2** The 2019 CCA would be based on a UCC calculated as though 100 percent of the available CCA had been taken in 2018. As the AccII provisions were not in place for 2018, the 100 percent CCA for 2018 would be $4,500 [(50%)(30%)($30,000)]. Using this figure, the deductible 2019 CCA would be $6,120 [(80%)(30%)($30,000 - $4,500)]. Note that the original base for CCA is limited to the Class 10.1 maximum of $30,000.

### *Property Income*

The required calculations here would be as follows:

| | |
|---|---|
| Non-Eligible Dividends | $ 5,400 |
| Gross Up On Non-Eligible Dividends [(15%)($5,400)] | 810 |
| Net Rental Income (Note 3) | 9,500 |
| Net Property Income | $15,710 |

**Note 3** As the change in use is from personal to business, the base for calculating CCA would be as follows:

| | | |
|---|---|---|
| Cost Of Building ($250,000 - $75,000) | | $175,000 |
| Fair Market Value At Change In Use ($375,000 - $100,000) | $275,000 | |
| Cost | ( 175,000) | |
| Increase In Value (Bump Up) | $100,000 | |
| Inclusion Factor | 1/2 | 50,000 |
| Cost For UCC And CCA Purposes | | $225,000 |
| One-Half Net Additions [(1/2)(($225,000)] | | ( 112,500) |
| CCA Base | | $112,500 |
| Rate For Class 1 | | 4% |
| CCA | | $ 4,500 |

Using this CCA figure, net rental income would be $9,500 ($14,000 - $4,500).

### *Net Taxable Capital Gains*

The required calculations here would be as follows:

| | | |
|---|---|---|
| Stock Option Shares [(1,500)($22 - $19)] | | $ 4,500 |
| Sale Of Paintings (Note 4) | | Nil |
| Land Sale | | |
| Total Gain ($350,000 - $100,000) | $250,000 | |
| Reserve For Land Sale (Note 5) | ( 178,571) | 71,429 |
| Change In Use: | | |
| Cottage - Land ($100,000 - $75,000) | $ 25,000 | |
| Cottage - Building ($275,000 - $175,000) | 100,000 | 125,000 |
| Net Capital Gains | | $200,929 |
| Inclusion Rate | | 1/2 |
| Net Taxable Capital Gains | | $100,465 |

**Note 4** The paintings would be listed personal property, which means that losses are only deductible to the extent of gains on listed personal property. While there was a gain on one painting of $5,000 ($15,000 - $10,000), there was a loss on the second painting of $6,000 ($10,000 - $4,000). This loss can be used to eliminate the gain on the first painting. However, the remaining $1,000 ($6,000 - $5,000) cannot be deducted in the current year. It can be carried back 3 years and forward 7 years to be applied against listed personal property gains in those years.

**Note 5** The total proceeds of disposition for the land would be $350,000 [$100,000 + (5)($50,000)]. Given this, the gain on the land would be $250,000 ($350,000 - $100,000). The maximum reserve would be $178,571, the lesser of:

- $178,571 [($250,000)($250,000 ÷ $350,000)]
- $200,000 [($250,000)(20%)(4 - 0)]

### Net And Taxable Income

The required calculations here would be as follows:

| | |
|---|---|
| Net Employment Income | $138,710 |
| Net Property Income | 15,710 |
| Net Taxable Capital Gains | 100,465 |
| **Net Income For Tax Purposes** | **$254,885** |
| Stock Option Deduction [(1/2)($6,000)] | ( 3,000) |
| **Taxable Income** | **$251,885** |

### Federal Tax Payable

The required calculations here would be as follows:

| | | |
|---|---|---|
| Tax On First $210,371 | | $48,719 |
| Tax On Next $41,514 ($251,885 - $210,371) At 33 Percent | | 13,670 |
| Tax Before Credits | | $62,389 |
| Tax Credits: | | |
| Basic Personal Amount | ($12,069) | |
| Spouse ($12,069 - $8,400) | ( 3,669) | |
| Canada Caregiver For Child - May | ( 2,230) | |
| Transfer Of May's Disability | ( 8,416) | |
| Disability Supplement | ( 4,909) | |
| Transfer Of Tuition Credit (Note 6) | ( 5,000) | |
| Medical Expenses (Note 7) | ( 14,448) | |
| EI | ( 860) | |
| CPP | ( 2,749) | |
| Canada Employment | ( 1,222) | |
| Total Credit Base | ($55,572 | |
| Rate | 15% | ( 8,336) |
| Subtotal | | $54,053 |
| Charitable Donations Credit (Note 8) | | ( 360) |
| Non-Eligible Dividend Tax Credit [(9/13)($810)] | | ( 561) |
| Federal Tax Payable | | $53,132 |

**Note 6** The transfer of Virginia's tuition credit would be $5,000, the lesser of:

- $5,000
- $9,350

**Note 7** The base for the medical expense tax credit would be calculated as follows:

| | |
|---|---|
| Total Medical Expenses | $16,800 |
| Lesser Of: | |
| • [(3%)($254,885)] = $7,647 | |
| • 2019 Threshold Amount = $2,352 | ( 2,352) |
| Medical Expense Tax Credit Base | $14,448 |

**Note 8** The charitable donations tax credit would be calculated as follows:

| | |
|---|---|
| 15 Percent Of $200 | $ 30 |
| 33 Percent Of The Lesser Of: | |
| $1,200 - $200 = $1,000 | |
| $251,885 - $210,371 = $41,514 | 330 |
| 29 Percent Of Nil ($1,200 - $1,200) | Nil |
| Total Credit | $360 |

## Self Study Solution Eight - 18

### *Employment Income*

Lorenzo's commission income of $43,000 is large enough not to limit the deduction of his employment related expenses. The required calculations here would be as follows:

| | |
|---|---|
| Salary | $136,000 |
| Additions | |
| Commissions | 43,000 |
| One-Half Total Bonus (Note 1) | 11,000 |
| Expense Allowance [(12)($2,500)] | 30,000 |
| Stock Option Benefit [(500)($108 - $92)] | 8,000 |
| Deductions | |
| RPP Contributions | ( 4,200) |
| Professional Association Dues | ( 1,500) |
| Automobile Costs | |
| CCA (Note 2) | ( 6,120) |
| Operating Costs [(80%)($6,300)] | ( 5,040) |
| Hotel Costs | ( 9,700) |
| Airline And Other Transportation | ( 5,400) |
| Client Meals And Entertainment [(1/2)($9,300)] | ( 4,650) |
| Workspace In Home Expenses (Note 3) | ( 978) |
| Net Employment Income | $190,412 |

**Note 1** As the bonus is paid more than 180 days after the employer's year end, the employer will not be able to deduct the accrual in 2019. This, however, does not change Lorenzo's tax position. He will not have to include one-half of the bonus in income until it is paid in 2020.

**Note 2** The 2019 CCA would be based on a UCC calculated as though 100 percent of the available CCA had been taken in 2018. As the AccII provisions did not come into effect until 2019, the 100 percent CCA of the Class 10.1 vehicle for 2018 would be $4,500 [(50%)(30%)($30,000 maximum)]. Using this figure, the deductible 2019 CCA would be $6,120 [(80%)(30%)($30,000 - $4,500)].

**Note 3** As Lorenzo has commission income, he can deduct 12 percent of all of the costs except the mortgage interest. This will provide a deduction of $978 [(12%)($1,250 + $1,300 + $5,600)].

### Property Income

The required calculations here would be as follows:

| | |
|---|---|
| Net Rental Income (Note 4) | $2,610 |
| Income Trust Distribution [(500)($2.40)] | 1,200 |
| Eligible Dividends | 4,200 |
| Gross Up On Eligible Dividends [(38%)($4,200)] | 1,596 |
| Total Property Income | $9,606 |

**Note 4** As the change in use is from personal to business, the base for calculating CCA would be as follows:

| | | |
|---|---|---|
| Cost Of Building ($105,000 - $42,000) | | $63,000 |
| Fair Market Value At Change In Use ($350,000 - $100,000) | $250,000 | |
| Cost | ( 63,000) | |
| Increase In Value (Bump Up) | $187,000 | |
| Inclusion Factor | 1/2 | 93,500 |
| Cost For UCC And CCA Purposes | | $156,500 |
| One-Half Net Additions [(1/2)($156,500)] | | ( 78,250) |
| CCA Base | | $ 78,250 |
| Rate For Class 1 | | 4% |
| CCA | | $ 3,130 |

Using this CCA figure, net rental income would be $2,610 ($5,740 - $3,130).

### Net Taxable Capital Gains

The required calculations here would be as follows:

| | | |
|---|---|---|
| Stock Option Shares [(500)($115 - $108)] | | $ 3,500 |
| Sculpture (Note 5) | | 38,000 |
| Change In Use: | | |
| Cottage - Land ($100,000 - $42,000) | $ 58,000 | |
| Cottage - Building ($250,000 - $63,000) | 187,000 | 245,000 |
| Real Property Income Trust (Note 6) | | 2,161 |
| Land Sale ($180,000 - $78,000) | $102,000 | |
| Reserve For Land Sale (Note 7) | ( 71,400) | 30,600 |
| Net Capital Gains | | $319,261 |
| Inclusion Rate | | 1/2 |
| Net Taxable Capital Gains | | $159,631 |

**Note 5** As the actual adjusted cost base of this personal use property is less than $1,000, its deemed adjusted cost base is $1,000 (the floor). This results in a gain of $38,000 ($39,000 - $1,000).

**Note 6** The $1,200 income trust distribution was used to acquired 20.51 additional units ($1,200 ÷ $58.50). Using this figure, the capital gain calculation would be:

| | |
|---|---|
| Proceeds Of Disposition [(520.51)($60.25)] | $31,361 |
| Adjusted Cost Base [(500)($56) + $1,200)] | ( 29,200) |
| Capital Gain | $ 2,161 |

**Note 7** The gain on the land would be $102,000 ($180,000 - $78,000). The maximum reserve would be $71,400, the lesser of:

- $71,400 [($102,000)($126,000 ÷ $180,000)]
- $81,600 [($102,000)(20%)(4 - 0)]

### *Net And Taxable Income*

The required calculations here would be as follows:

| | |
|---|---|
| Net Employment Income | $190,412 |
| Property Income | 9,606 |
| Net Taxable Capital Gains | 159,631 |
| Net Income For Tax Purposes | $359,649 |
| Stock Option Deduction [(1/2)($8,000)] | ( 4,000) |
| Taxable Income | $355,649 |

### *Federal Tax Payable*

The required calculations here would be as follows:

| | | |
|---|---|---|
| Tax On First $210,371 | | $48,719 |
| Tax On Next $145,278 ($355,649 - $210,371) At 33 Percent | | 47,942 |
| Tax Before Credits | | $96,661 |
| Tax Credits: | | |
| Basic Personal Amount | ($12,069) | |
| Spouse ($12,069 - $6,300) | ( 5,769) | |
| Canada Caregiver For Child - Anita | ( 2,230) | |
| Transfer Of Anita's Disability | ( 8,416) | |
| Disability Supplement | ( 4,909) | |
| Transfer Of Tuition - Lesser Of: | | |
| • Absolute Limit Of $5,000 | | |
| • Actual Tuition Of $9,300 | ( 5,000) | |
| Medical Expenses (Note 8) | ( 15,273) | |
| EI | ( 860) | |
| CPP | ( 2,749) | |
| Canada Employment | ( 1,222) | |
| Total Credit Base | ($58,497) | |
| Rate | 15% | ( 8,775) |
| Subtotal | | $87,886 |
| Charitable Donations Credit (Note 9) | | ( 756) |
| Dividend Tax Credit [(6/11)($1,596)] | | ( 871) |
| Federal Tax Payable | | $86,259 |

**Note 8** The base for the medical expense tax credit would be calculated as follows:

| | |
|---|---|
| Total Medical Expenses | $17,625 |
| Lesser Of: | |
| • [(3%)($359,649))] = $10,789 | |
| • 2019 Threshold Amount = $2,352 | ( 2,352) |
| Medical Expense Tax Credit Base | $15,273 |

**Note 9** The charitable donations tax credit would be calculated as follows:

| | |
|---|---|
| 15 Percent Of $200 | $ 30 |
| 33 Percent Of The Lesser Of: | |
| $2,200 ($2,400 - $200) | |
| $145,278 ($355,649 - $210,371) | 726 |
| 29 Percent Of Nil ($2,200 - $2,200) | Nil |
| Total Credit | $756 |

## Chapter 8 Learning Objectives

After completing Chapter 8, you should be able to:

1. Explain the economic basis for treating capital gains more favourably than other types of income (paragraph [P hereafter] 8-1 to 8-10).
2. Apply the general rules for the determination of gains and losses on the disposition of capital assets (P 8-11 to 8-36).
3. Calculate capital gains and losses on dispositions of identical properties (P 8-37 to 8-38).
4. Determine the tax consequences associated with partial dispositions of capital assets (P 8-39).
5. Calculate capital gains and losses on dispositions of capital assets with warranties attached (P 8-40 to P 8-41).

6. Apply the rules related to capital gains reserves (P 8-42 to 8-61).
7. Determine the tax consequences of a bad debt arising on a debt from the sale of capital assets (P 8-62 and 8-63).
8. Apply the special rule for sales of real property (P 8-64 to 8-71).
9. Apply the basic rules related to the reduction of taxation of capital gains arising from the disposition of a principal residence (P 8-72 to 8-81).
10. Describe the approaches available on the disposition of farm property that is also a principal residence (P 8-82 to 8-86).

11. Determine the tax consequences that result from dispositions of personal use property (P 8-87 to 8-91).
12. Determine the tax consequences that result from dispositions of listed personal property (P 8-92 to 8-94).
13. Determine the tax consequences that result from foreign currency transactions (P 8-95 to 8-106).
14. Determine the tax consequences that result from dispositions of options (P 8-107 to 8-112).
15. Determine the amount of capital gain or loss resulting from a change in the use of a capital asset (P 8-113 to 8-121).

16. Describe the principal residence elections that are available when there is a change in use (P 8-122 to 8-130).
17. Describe how an individual deals with the CCA on automobiles where the amount of employment or business usage changes over time. (P 8-131).
18. Explain the basic requirements for deemed dispositions on departures from Canada (P 8-132 to 8-133).
19. Apply the deferral provisions for capital gains arising on the disposition of small business investments (P 8-134 to 8-136).
20. Apply the deferral provisions for capital gains arising on voluntary and involuntary dispositions of property that is subsequently replaced (P 8-137 to 8-149).
21. Apply the deferral provisions for recapture arising on voluntary and involuntary dispositions of capital property that is subsequently replaced (P 8-150 to 8-165).
22. Explain the role of capital gains and losses in tax planning (P 8-166 to 8-168).

# CHAPTER 9

## How To Work Through Chapter 9

We recommend the following approach in dealing with the material in this Chapter:

**Coverage And Organization Of Chapter 9**

- Read paragraph 9-1 to 9-10 (in the textbook).

**Inclusions - Pension Benefits, Retiring Allowances, And Death Benefits**

- Read paragraph 9-11 to 9-19.

**Inclusions - Deferred Income Plans, Scholarships, Social Assistance Payments, Universal Child Care Benefits**

- Read paragraph 9-20 to 9-27.

**Deductions - CPP Contributions On Self-Employed Earnings**

- Read paragraph 9-28 to 9-31.

**Deductions - Moving Expenses**

- Read paragraph 9-32 to 9-45.
- Do Exercise Nine-1 (in the textbook) and check the solution in this Study Guide.
- Do Self Study Problem Nine-1 which is available on MyLab and check the solution in this Study Guide.

**Deductions - Child Care Expenses**

- Read paragraph 9-46 to 9-57.
- Do Exercise Nine-2 and check the solution in this Study Guide.
- Do Self Study Problems Nine-2 and Nine-3 and check the solutions in this Study Guide.

**Deductions - Disability Supports Deduction**

- Read paragraph 9-58 to 9-66.
- Do Exercise Nine-3 and check the solution in this Study Guide.

**Related Inclusions/Deductions - Employment Insurance Benefits**

- Read paragraph 9-67 and 9-68.

**Related Inclusions/Deductions - Pension Income Splitting**

- Read paragraph 9-69 to 9-77.
- Do Exercise Nine-4 and check the solution in this Study Guide.
- Do Self Study Problems Nine-4 and Nine-5 and check the solutions in this Study Guide.

**Related Inclusions/Deductions - Spousal And Child Support**

- Read paragraph 9-78 to 9-87.
- Do Exercise Nine-5 and check the solution in this Study Guide.

**Related Inclusions/Deductions - Annuity Payments Received**

- Read paragraph 9-88 to 9-96.
- Do Exercise Nine-6 and check the solution in this Study Guide.

**Tax Free Savings Accounts (TFSAs)**

- Read paragraph 9-97 to 9-101.

**Registered Education Savings Plans (RESPs), Canada Education Savings Grants**

- Read paragraph 9-102 to 9-110.
- Do Exercise Nine-7 and check the solution in this Study Guide.
- Read paragraph 9-111 to 9-129.
- Do Self Study Problem Nine-6 and check the solution in this Study Guide.

**Comparison of TFSAs, RRSPs And RESPs**

- Read paragraph 9-130 to 9-138.

**Registered Disability Savings Plans (RDSPs)**

- Read paragraph 9-139 to 9-141.

**Non-Arm's Length Transfers Of Property - Inadequate Considerations (ITA 69)**

- Read paragraph 9-142 to 9-156.
- Do Exercise Nine-8 and check the solution in this Study Guide.
- Read paragraph 9-157 to 9-159.
- Do Exercise Nine-9 and check the solution in this Study Guide.
- Do Self Study Problem Nine-7 and check the solution in this Study Guide.

**Inter Vivos Transfers To A Spouse**

- Read paragraph 9-160 to 9-167.
- Do Exercise Nine-10 and check the solution in this Study Guide.

**Non-Arm's Length Transfers Of Depreciable Assets**

- Read paragraph 9-168 to 9-172.
- Do Exercises Nine-11 and Nine-12 and check the solutions in this Study Guide.
- Do Self Study Problem Nine-8 and check the solution in this Study Guide.

**Inter Vivos Transfer Of Farm Or Fishing Property To A Child**

- Read paragraph 9-173 to 9-176.
- Do Exercise Nine-13 and check the solution in this Study Guide.

**Deemed Dispositions - On Death**

- Read paragraph 9-177 to 9-185.
- Do Exercise Nine-14 and check the solution in this Study Guide.
- Read paragraph 9-186.
- Do Self Study Problem Nine-9 and check the solution in this Study Guide.

**Income Attribution**

- Read paragraph 9-187 to 9-205.
- Do Exercises Nine-15 to Nine-17 and check the solutions in this Study Guide.
- Read paragraph 9-206 to 9-209.
- Do Self Study Problems Nine-10 and Nine-11 and check the solutions in this Study Guide.

**Anti-Avoidance Provisions And Tax Planning**

- Read paragraph 9-210 to 9-212.
- Do Self Study Problems Nine-12 and Nine-13 and check the solutions in this Study Guide.

### To Complete This Chapter

- If you would like more practice in problem solving, do the Supplementary Self Study Problems for the chapter. These are available on MyLab.
- Review the Key Terms Used In This Chapter in the textbook at the end of Chapter 9. Consult the Glossary for the meaning of any key terms you do not know.
- Test yourself with the Chapter 9 Glossary Flashcards available on MyLab.
- Ensure you have achieved the Chapter 9 Learning Objectives listed in this Study Guide.
- As a review, we recommend you view the PowerPoint presentation for Chapter 9 that is on MyLab.

### Practice Examination

- Write the Practice Examination for Chapter 9 that is on MyLab. Mark your examination using the Practice Examination Solution that is also on MyLab.

## Solutions to Chapter Nine Exercises

### *Exercise Nine - 1 Solution*

Ms. Chevlak cannot deduct the $1,300 house hunting trip. However, this amount can be reimbursed by her employer without creating a taxable benefit. Given these facts, the employer should reimburse this amount directly, with the balance of $4,700 being paid as a general moving allowance. The amount that can be deducted in 2019 against this general allowance, as well as the amount to be carried forward would be calculated as follows:

| | |
|---|---|
| Allowance Paid By Employer ($6,000 - $1,300) | $4,700 |
| Moving Costs | ( 6,400) |
| Lease Penalty | ( 1,200) |
| Available Deduction | ($2,900) |
| Income At New Location = Maximum Deduction | 2,000 |
| Carry Forward | ($ 900) |

The maximum moving expense deduction is limited to $2,000, the income at the new location. The remaining $900 can be carried forward and deducted against income earned at the new location in a subsequent year.

If a $6,000 moving allowance had been paid, the full amount would have been included in employment income with the same deductions of $7,600 ($6,400 + $1,200). After the $2,000 in income, this would have left $400 in income rather than a future deduction of $900. The $1,300 difference is the cost of the house hunting trip.

### *Exercise Nine - 2 Solution*

The deduction will have to be made by the lower income spouse, Mr. Sampras. The deduction will be the least of the following amounts:

- The actual costs of $10,500.
- Annual Child Care Expense Amount of $18,000 [(1)($8,000) + (2)($5,000)].
- 2/3 of Mr. Sampras' earned income, an amount of $13,000 [(2/3)($14,000 + $5,500)].

The least of these three amounts is $10,500.

### Exercise Nine - 3 Solution

As Jose is not eligible for the disability tax credit, he will deduct the cost of full time attendant care under ITA 64. When combined with the other disability support costs and the reimbursement, the qualifying costs total $36,000 ($23,000 + $18,000 - $5,000). As this is less than his income from employment, he will be able to deduct the full amount of these costs as his disability supports deduction.

### Exercise Nine - 4 Solution

In the absence of pension income splitting John would not pay any taxes for 2019. Joanna's Net Income For Tax Purposes before any OAS clawback would be $92,400 ($85,000 + $7,400). There would be an OAS clawback of $2,223 [(15%)($92,400 - $77,580), leaving Joanna with a Net and Taxable Income of $90,177 ($92,400 - $2,223). Based on this figure, her 2019 Amount Owing would be calculated as follows:

| | | |
|---|---|---|
| Tax Of First $47,630 | | $ 7,145 |
| Tax On Next $42,547 ($90,177 - $47,630) At 20.5% | | 8,722 |
| Total Before Credits | | $15,867 |
| Basic Personal | ($12,069) | |
| Credits: | | |
| Spousal ($12,069 - $7,400) | ( 4,669) | |
| Age [$7,494 - (15%)($90,177 - $37,790) | Nil | |
| Pension | ( 2,000) | |
| Spouse's Age | ( 7,494) | |
| Total | ($26,232) | |
| Rate | 15% | ( 3,935) |
| Federal Tax Payable | | $11,932 |
| OAS Clawback | | 2,223 |
| Total Amount Owing - Joanna Only | | $14,155 |

If maximum pension splitting is used, it will give both Joanna and John Net and Taxable Income of $49,900 [($85,000)(1/2) + $7,400]. Since this is below the income threshold, there will be no clawback of OAS for Joanna or John. Based on these figures, the Amount Owing for both Joanna and John would be the same and is calculated as follows:

| | | |
|---|---|---|
| Tax On First $47,630 | | $7,145 |
| Tax On Next $2,270 ($49,900 - $47,630) At 20.5% | | 465 |
| Total Before Credits | | $7,610 |
| Credits: | | |
| Basic Personal | ($12,069) | |
| Age [$7,494 - (15%)($49,900 - $37,790) | ( 5,678) | |
| Pension | ( 2,000) | |
| Total | ($19,747) | |
| Rate | 15% | ( 2,962) |
| Federal Tax Payable | | $ 4,648 |
| OAS Clawback | | Nil |
| Total Amount Owing For Each | | $ 4,648 |

With pension income splitting, the total amount owing by Joanna and John would be $9,296 [(2)($4,648)]. This is an improvement of $4,859 over the $14,155 that Joanna would have paid without income splitting. Further savings would be available at the provincial level.

### Exercise Nine - 5 Solution

The total required child support is $9,000 [(6 Months)($1,500)] and Sandra's $12,000 [(3)($1,500 + $2,500)] in payments will be allocated to this requirement first. This means that $9,000 of her payment will not be deductible to her or taxable to Jerry. The remaining $3,000 ($12,000 - $9,000) will be considered a payment towards spousal support and will be deductible to Sandra and taxable to Jerry.

### Exercise Nine - 6 Solution

A total of $63,492 [(4)($15,873)] in payments will be received from this annuity. The $15,873 will be included in his annual tax return. However, because the annuity was purchased with after tax funds, he is eligible for a deduction equal to:

$$\left[\frac{\$55,000}{\$63,492}\right][\$15,873] = \underline{\underline{\$13,750}} \text{ Deduction}$$

As a result, Mr. Hollock's Net Income For Tax Purposes will increase by $2,123 ($15,873 - $13,750) each year.

### Exercise Nine - 7 Solution

For 2018, the contributions to Jeanine's RESP total $1,700 ($500 + $1,200). This is within the $2,500 limit for contributions eligible for CESGs. This means that the 2018 CESG would be calculated as follows:

| | |
|---|---:|
| First $500 At 40 Percent | $200 |
| Remaining $1,200 ($1,700 - $500) At 20 Percent | 240 |
| Total CESG For 2018 | $440 |

For 2019, the contributions to Jeanine's RESP total $3,900 ($1,500 + $2,400). The CESG room is limited to $3,300 [(2)($2,500) - $1,700 from the previous year]. This means that $600 ($3,900 - $3,300) of the total contributions will not be eligible for CESGs. Given this, the 2019 CESG would be calculated as follows:

| | |
|---|---:|
| First $500 At 40 Percent | $200 |
| Remaining $2,800 ($3,300 - $500) At 20 Percent | 560 |
| Total CESG For 2019 | $760 |

If it is expected that annual contributions to Jeanine's RESP will be less than $2,500 in the future, this would suggest that Jeanine's father should limit his 2019 contribution to $900 and defer the extra $600 to the following year. In that year, it would be eligible for the CESG.

### Exercise Nine - 8 Solution

Mr. Lipky's proceeds of disposition will be the amount received of $95,000, resulting in a capital loss of $5,000 ($95,000 - $100,000). His brother's adjusted cost base will be the fair market value of the land, or $75,000, and he will have no gain or loss on his sale at $75,000. In this case, the application of the ITA 69 rules has resulted in the potential loss of $20,000 ($95,000 - $75,000) not being available to either Carl Lipky or his brother.

### Exercise Nine - 9 Solution

Under ITA 69(1.2), the proceeds of disposition in this case will be the greater of the $33,000 actual proceeds and the $211,000 fair market value of the property without considering the lease. The greater amount would be $211,000, resulting in a taxable capital gain for Mr. Bates of $89,000 [(1/2)($211,000 - $33,000)]. The adjusted cost base to the corporation would be the actual transfer price of $33,000. This would lead to double taxation on a subsequent sale of the property on the difference between $211,000 and $33,000.

### Exercise Nine - 10 Solution

**ITA 73(1) Applies** If Mr. Schwartz does not elect out of ITA 73(1), the results are as follows:

- His deemed proceeds of disposition will be equal to the $225,000 adjusted cost base of the land. Given this, there will be no tax consequences as a result of this transfer.
- The adjusted cost base to his spouse will be deemed to be $225,000, despite the fact that she paid $300,000 for the land.

**Elect Out Of ITA 73(1)** If Mr. Schwartz elects out of ITA 73(1):

- The adjusted cost base of the land to his spouse will be $300,000, the amount she paid.
- He will have to include a taxable capital gain in his Net Income For Tax Purposes calculated as follows:

| | |
|---|---|
| Proceeds Of Disposition | $300,000 |
| Adjusted Cost Base | ( 225,000) |
| Capital Gain | $ 75,000 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain | $ 37,500 |

### Exercise Nine - 11 Solution

**ITA 73(1) Applies** If Ms. Sharp does not elect out of ITA 73(1), the results will be as follows:

- The deemed proceeds to Ms. Sharp will be the $110,000 UCC value, resulting in no tax consequences for her at the time of transfer.
- For CCA and recapture purposes the spouse will receive the property at $110,000.
- Despite the fact that her spouse paid $225,000, he would retain her $175,000 capital cost, with the difference between $175,000 and the $110,000 UCC balance considered to be deemed CCA.

**Elect Out Of ITA 73(1)** If Ms. Sharp elects out of ITA 73(1):

- For capital gains purposes, the capital cost for Ms. Sharp's husband would be $225,000. However, for CCA and recapture purposes, ITA 13(7)(e) would deem his capital cost to be $200,000 [($175,000 + (1/2)($225,000 - $175,000)].
- She will include the following amounts in her Net Income For Tax Purposes:

| | |
|---|---|
| Proceeds Of Disposition | $225,000 |
| Capital Cost | ( 175,000) |
| Capital Gain | $ 50,000 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain | $ 25,000 |

| | |
|---|---|
| UCC | $110,000 |
| Deduct Lesser Of: | |
| Proceeds Of Disposition = $225,000 | |
| Capital Cost = $175,000 | ( 175,000) |
| Negative Ending Balance = Recapture Of CCA | ($ 65,000) |

### Exercise Nine - 12 Solution

**Ms. Lee** The tax consequence for Ms. Lee is as follows:

| | |
|---|---|
| UCC For Ms. Lee | $37,200 |
| Deduct Lesser Of: | |
| Proceeds Of Disposition = $40,000 | |
| Capital Cost = $53,000 | ( 40,000) |
| Negative Ending Balance = Recapture Of CCA | ($ 2,800) |

**Ms. Lee's Father** As this was a non-arm's length transfer at a value below the transferor's capital cost, ITA 13(7)(e) will deem the father's capital cost to be equal to Ms. Lee's capital cost of $53,000. The $13,000 difference between this value and the $40,000 he paid for the asset is treated as deemed CCA, resulting in a UCC value of $40,000. When he later sells the asset for $44,000, the result will be as follows:

| | |
|---|---|
| UCC For Ms. Lee's Father | $40,000 |
| Deduct Lesser Of: | |
| Proceeds Of Disposition = $44,000 | |
| Deemed Capital Cost = $53,000 | ( 44,000) |
| Negative Ending Balance = Recapture Of CCA | ($ 4,000) |

### Exercise Nine - 13 Solution

With respect to the land, the $280,000 paid is between the $250,000 adjusted cost base floor and the $325,000 fair market value ceiling. Therefore, the proceeds of disposition would be $280,000, resulting in a taxable capital gain for Mr. Nobel of $15,000 [(1/2)($280,000 - $250,000]). The $280,000 would also be the adjusted cost base for his daughter.

With respect to the barn, as there was no consideration given, the transfer would take place at the UCC floor of $85,000. There would be no tax consequences for Mr. Nobel. With respect to his daughter, she would assume a UCC value of $85,000 but would retain the original capital cost of $115,000. The $30,000 difference would be considered deemed CCA.

### Exercise Nine - 14 Solution

With respect to truck A, it would be transferred to her husband at its UCC value of $25,500 [(1/2)($51,000)]. No income would be included in Ms. Lardner's final tax return and, while the UCC value for the truck in Michel's hands would be the $25,500 transfer value, it would retain its original capital cost of $42,000 with the difference between the two values being treated as deemed CCA.

Truck B would be transferred to Melinda at its fair market value of $33,000. This means that the proceeds of disposition for the two trucks would be $58,500 ($25,500 + $33,000). This would result in recapture of $7,500 ($51,000 - $58,500) being included in Ms. Lardner's final tax return. The $33,000 transfer price would be the UCC value to Melinda. Since Ms. Lardner's original capital cost exceeds the $33,000 fair market value, Melinda would retain Ms. Lardner's $42,000 capital cost with the difference between the two values being treated as deemed CCA.

### Exercise Nine - 15 Solution

> **NOTE** You may find it helpful to review Exercises Nine-10 and Nine-11 before completing this Exercise as many students find the rules related to the ITA 73(1) roll-overs difficult to understand.

ITA 73(1) provides for a tax free rollover of capital property to a spouse. The tax consequences for Mr. and Mrs. Moreau for the two years can be outlined as follows:

- 2018 for Mr. Moreau - none.
- 2018 for Mrs. Moreau - none.
- 2019 for Mr. Moreau - none.
- 2019 for Mrs. Moreau - total income of $12,950. She would have taxable dividends of $3,450 and the taxable capital gain of $9,500 [(1/2)($42,000 - $23,000)] attributed to her.

### Exercise Nine - 16 Solution

There is no provision for a tax free transfer of shares to a child. The tax consequences for Norah and Nicki Moreau for the two years can be outlined as follows:

- 2018 for Nicki - none.
- 2018 for Norah - a taxable capital gain of $7,000 [(1/2)($37,000 - $23,000)].
- 2019 for Nicki - a taxable capital gain of $2,500 [(1/2)($42,000 - $37,000)].
- 2019 for Norah - taxable dividends of $3,450 attributed to her.

### Exercise Nine - 17 Solution

Since Mr. Bronski does not elect out of ITA 73(1) by including a gain on his tax return at the time of the transfer, the income attribution rules will apply. Even if he did elect out of ITA 73(1), the rules would still apply as the loan does not bear interest at the prescribed rate.

There will be no tax consequences for either Mr. or Mrs. Bronski in 2018. Because the transfer is a tax free rollover, the adjusted cost base of the bonds to Mrs. Bronski will be $115,000. All of the 2019 interest income of $6,100 will be attributed to Mr. Bronski. In addition to the interest of $6,100, there would be a taxable capital gain of $7,000 [(1/2)($129,000 - $115,000)], which would also be attributed to Mr. Bronski. The total addition to Mr. Bronski's income for 2019 is $13,100 ($6,100 + $7,000). There will be no tax consequences for Mrs. Bronski in 2019.

## Self Study Solution Nine - 1

Costs for food and lodging at or near an old or new residence are limited to a maximum period of 15 days. Note that the 9 days spent travelling to Vancouver are not included in the 15 day total. Since the daily costs for her Montreal stay are higher than those for her Vancouver stay, she claims the 15 day maximum at the Montreal rate.

The deductible moving expenses can be calculated as follows:

| | | |
|---|---|---|
| House Hunting Trip Hotel And Food (Not Deductible) | | Nil |
| Real Estate Commission - Montreal Home | | $27,500 |
| Legal Fees - Montreal Home | | 800 |
| Other Montreal Home Costs (Not Deductible) | | Nil |
| Storage Costs | | 2,200 |
| Moving Company Charges | | 10,200 |
| Hotel In Montreal (15 Nights At $350) | | 5,250 |
| Food - Maximum (15 Days At $51 Flat Rate) | | 765 |
| Expenses Of Travel To Vancouver: | | |
| Gas (Using Simplified Method) | Nil | |
| Simplified Milage Rate [(4,558 @ $0.58) | $2,644 | |
| Hotel (9 Nights - Total) | 1,575 | |
| Food (9 Days At $51 Simplified Rate) | 459 | 4,678 |
| Vancouver Hotel | | Nil |
| Moving Expense Deductions Available | | $51,393 |

Moving costs can only be deducted against "income earned at the new work location". This raises the question as to whether the general moving allowance, compensation for house loss, and payment for higher housing costs would fall into this category. It would be our view that since these amounts were paid by the Vancouver office subsequent to Michelle commencing work at that location, they would qualify. Based on this view, the total employment income at the new work location would be as follows:

| | |
|---|---|
| Salary At New Location (One Month @ $15,000) | $15,000 |
| General Moving Allowance | 20,000 |
| Compensation For Loss On Montreal Residence (Note 1) | 30,000 |
| Payment For Higher Housing Costs (Note 2) | 10,000 |
| Total Employment Income At New Location | $75,000 |

**Note 1** Under ITA 6(20), one-half of any housing loss reimbursement in excess of $15,000 must be included in income. As the total reimbursement was $75,000 ($625,000 - $550,000), the inclusion would be $30,000 [(1/2)($75,000 - $15,000)].

**Note 2** Any amounts paid to compensate an employee for higher housing costs must be included in income in full.

As the deductible costs are less than the income at the new location, they are fully deductible in Michelle's 2019 tax return. There would be no carry forward of moving costs.

## Self Study Solution Nine - 2

***Mrs. Fortin***

Generally, the spouse with the lower income must claim the deduction for child care expenses. However, under certain circumstances, for example if this spouse is hospitalized, the spouse with the higher income can claim the deduction for the period of hospitalization. Thus Mrs. Fortin can claim the least of the following:

| | Case A | Case B |
|---|---|---|
| Actual Payments [($400)(48)] | $ 19,200 | $19,200 |
| 2/3 Of Earned Income [(2/3)($84,000)] | $56,000 | $56,000 |
| Annual Expense Limit: | | |
| Case A [(2)($8,000)] | $16,000 | |
| Case B [(2)($8,000) + (1)($5,000)] | | $21,000 |
| Periodic Expense Limit: | | |
| Case A [(2)($200)(6 weeks)] | $ 2,400 | |
| Case B {[(2)($200)(6 weeks)] + [(1)($125)(6 weeks)]} | | $ 3,150 |

In Case A, the least of these figures is $2,400, the Periodic Expense Limit. In Case B, the least of the figures is $3,150, also the Periodic Expense Limit.

***Mr. Fortin***

The calculations for Mr. Fortin are as follows:

| | Case A | Case B |
|---|---|---|
| Actual Payments | $19,200 | $19,200 |
| 2/3 Of Earned Income [(2/3)($8,000)] | $ 5,333 | $ 5,333 |
| Annual Expense Limit: | | |
| Case A [(2)($8,000)] | $16,000 | |
| Case B [(2)($8,000) + (1)($5,000)] | | $21,000 |

The lowest figure in both cases is $5,333, two-thirds of Mr. Fortin's earned income. Mr. Fortin's deduction for the current year will be reduced by the amount claimed by Mrs. Fortin. Mr. Fortin's deduction for the current year is $2,933 ($5,333 - $2,400) in Case A, and $2,183 ($5,333 - $3,150) in Case B.

## Self Study Solution Nine - 3

The deductible actual costs are as follows:

| | |
|---|---|
| Actual Costs Excluding Camp Costs (48 weeks At $260) | $12,480 |
| Periodic Cost Limit For Camp Weeks [($125)(1)(4 weeks) + ($200)(1)(4 weeks) + ($275)(1)(4 weeks)] | 2,400 |
| Deductible Actual Costs | $14,880 |

Generally, the common-law partner with the lower income must claim the deduction for child care expenses. In this case, that would be Sue Brendal. However, under certain circumstances, the common-law partner with the higher income can claim a deduction that is subject to a weekly limitation.

One of these circumstances is when the lower income common-law partner is in attendance on a full time basis at a designated financial institution. This means that for the 5 week period that Sue is attending the accounting course, Maureen can deduct limited child care expenses.

The calculations for determining the deductible costs for each individual are as follows:

| | Maureen | Sue |
|---|---|---|
| Actual Costs And Limited Camp Costs | $14,880 | $14,880 |
| Annual Expense Limit [($5,000)(1) + ($8,000)(1) + ($11,000)(1)] | $24,000 | $24,000 |
| 2/3 Of Earned Income | | |
| [(2/3)($216,000)] | $144,000 | |
| [(2/3)($24,000)] | | $16,000 |
| Periodic Expense Limit [($125)(1)(5 weeks) + ($200)(1)(5 weeks) + ($275)(1)(5 weeks)] | $3,000 | N/A |

The least of these amounts for Maureen is $3,000. You should note that there is no requirement that actual payments be allocated on the basis of the time that Sue was attending the accounting course.

The lowest figure for Sue is $14,880, the actual child care costs. Sue's deduction for the current year of $11,880 ($14,880 - $3,000) has been reduced by the amount claimed by Maureen.

As Maureen is the higher income common-law partner, her 3 week stay in the hospital has no effect on the child care expense calculations.

## Self Study Solution Nine - 4

### *Net And Taxable Income*

| John's Income | No Split | With Split |
|---|---|---|
| Pension Receipt | $ 64,000 | $64,000 |
| Net Rental Income | 23,000 | 23,000 |
| Pension Income To Fatima | N/A | ( 32,000) |
| Net And Taxable Income | $87,000 | $55,000 |

| Fatima's Income | No Split | With Split |
|---|---|---|
| Interest Income | $8,400 | $ 8,400 |
| Pension Income From John | N/A | 32,000 |
| Net And Taxable Income | $8,400 | $40,400 |

### *Federal Tax Payable With No Pension Income Splitting*

**Fatima** Fatima's federal Tax Payable with no pension income splitting would be calculated as follows:

| | |
|---|---|
| Tax Before Credits [(15%)($8,400)] | $1,260 |
| Basic Personal Credit [(15%)($12,069)] | ( 1,810) |
| Federal Tax Payable - Fatima | Nil |

**John** Without pension income splitting, John's Tax Payable would be calculated as follows:

| | | |
|---|---|---|
| Tax Of First $47,630 | | $7,145 |
| Tax On Next $39,370 ($87,000 - $47,630) At 20.5% | | 8,071 |
| Total Before Credits | | $15,216 |
| Credits: | | |
| Basic Personal | ($12,069) | |
| Spousal ($12,069 - $8,400) | ( 3,669) | |
| Pension | ( 2,000) | |
| Total | ($17,738) | |
| Rate | 15% | ( 2,661) |
| Federal Tax Payable - John | | $12,555 |

### *Federal Tax Payable With Pension Income Splitting*

**Fatima** When pension income splitting is used, Fatima's Tax Payable would be as follows:

| | | |
|---|---|---|
| Tax Before Credits [(15%)($40,400)] | | $6,060 |
| Credits: | | |
| Basic Personal | ($12,069) | |
| Pension | ( 2,000) | |
| Total | ($14,069) | |
| Rate | 15% | ( 2,110) |
| Federal Tax Payable - Fatima | | $ 3,950 |

**John** With pension income splitting, John's Tax Payable would be calculated as follows:

| | | |
|---|---|---|
| Tax On First $47,630 | | $7,145 |
| Tax On Next $7,370 ($55,000 - $47,630) At 20.5% | | 1,511 |
| Tax Before Credits | | $8,656 |
| Credits: | | |
| Basic Personal | ($12,069) | |
| Spousal | Nil | |
| Pension | ( 2,000) | |
| Total | ($14,069) | |
| Rate | 15% | ( 2,110) |
| Federal Tax Payable - John | | $6,546 |

***Comparison***

| | |
|---|---|
| Federal Tax Payable Without Income Splitting (John Only) | $12,555 |
| Federal Tax Payable With Income Splitting ($3,950 + $6,546 ) | ( 10,496) |
| Savings With Pension Income Splitting | $ 2,059 |

## Self Study Solution Nine - 5

***Part A - Net And Taxable Income***

| **Martin's Income** | **Scenario 1** | **Scenario 2** |
|---|---|---|
| Pension Receipt | $124,000 | $124,000 |
| Pension Income To Sally | N/A | ( 62,000) |
| OAS | N/A | 7,400 |
| Net Income Before OAS Clawback | $124,000 | $ 69,400 |
| OAS Clawback (Notes 1 and 2) | N/A | N/A |
| Net And Taxable Income - Martin | $124,000 | $ 69,400 |

| **Sally's Income** | **Scenario 1** | **Scenario 2** |
|---|---|---|
| OAS | $ 7,400 | $ 7,400 |
| Interest Earned | 43,000 | 43,000 |
| Pension Income From Martin | N/A | 62,000 |
| Net Income Before OAS Clawback | $50,400 | $112,400 |
| OAS Clawback (Note 3) | Nil | ( 5,223) |
| Net And Taxable Income - Sally | $50,400 | $107,177 |

**Note 1** As Martin did not apply for OAS in Scenario 1, there can be no clawback.

**Note 2** In Scenario 2, Martin's Net Income is less than the clawback income threshold of $77,580 so there is no clawback.

**Note 3** With pension income splitting, the OAS clawback for Sally would be $5,223 [(15%)($112,400 - $77,580)].

***Part B - Scenario 1***

Without pension income splitting, Martin's Amount Owing would be calculated as follows:

| | | |
|---|---|---|
| Tax On First $95,259 | | $16,908 |
| Tax On Next $28,741 ($124,000 - $95,259) At 26% | | 7,473 |
| Tax Before Credits | | $24,381 |
| Credits: | | |
| Basic Personal | ($12,069) | |
| Age [$7,494 - (15%)($124,000 - $37,790) | Nil | |
| Pension | ( 2,000) | |
| Total | ($14,069) | |
| Rate | 15% | ( 2,110) |
| Federal Tax Payable | | $22,271 |
| OAS Clawback | | N/A |
| Total Amount Owing - Martin | | $22,271 |

Without pension income splitting, Sally's Amount Owing would be calculated as follows:

| | | |
|---|---|---|
| Tax On First $47,630 | | $7,145 |
| Tax On Next $2,770 ($50,400 - $47,630) At 20.5% | | 568 |
| Tax Before Credits | | $7,713 |
| Credits: | | |
| Basic Personal | ($12,069) | |
| Age [$7,494 - (15%)($50,400 - $37,790) | ( 5,603) | |
| Disability | ( 8,416) | |
| Total | ($26,088) | |
| Rate | 15% | ( 3,913) |
| Total Amount Owing (No Clawback) - Sally | | $3,800 |

***Part B - Scenario 2***

With pension income splitting and the OAS payments, Martin's Amount Owing would be calculated as follows:

| | | |
|---|---|---|
| Tax On First $47,630 | | $7,145 |
| Tax On Next $21,770 ($69,400 - $47,630) At 20.5% | | 4,463 |
| Tax Before Credits | | $11,608 |
| Credits: | | |
| Basic Personal | ($12,069) | |
| Age [$7,494 - (15%)($69,400 - $37,790)] | ( 2,753) | |
| Pension | ( 2,000) | |
| Total | ($16,822) | |
| Rate | 15% | ( 2,523) |
| Total Amount Owing (No Clawback) - Martin | | $ 9,085 |

With pension income splitting, Sally's Amount Owing would be calculated as follows:

| | | |
|---|---|---|
| Tax On First $95,259 | | $16,908 |
| Tax On Next $11,918 ($107,177 - $95,259) At 26% | | 3,099 |
| Tax Before Credits | | $20,007 |
| Credits: | | |
| Basic Personal | ($12,069) | |
| Age [$7,494 - (15%)($107,177 - $37,790)] | Nil | |
| Disability | ( 8,416) | |
| Pension | ( 2,000) | |
| Total | ($20,485) | |
| Rate | 15% | ( 3,073) |
| Federal Tax Payable | | $16,934 |
| OAS Clawback | | 5,223 |
| Total Amount Owing - Sally | | $22,157 |

### *Part B - Comparison Of After Tax Income*

This amount would be calculated as follows:

| | | |
|---|---|---|
| Amount Owing - Scenario 1 ($22,271 + $3,800) | | $26,071 |
| Amount Owing - Scenario 2 ($9,085 + $22,157) | ($31,242) | |
| OAS Benefits Received - Scenario 2 | 7,400 | ( 23,842) |
| Cash Advantage - Scenario 2 | | $ 2,229 |

This problem illustrates the complexity associated with pension income splitting. Although Scenario 2 served to make the incomes more equal, it had several negative side effects (e.g., the clawback of a large part of Sally's OAS, as well as the elimination of her age credit.) However, there is a definite cash advantage to Scenario 2.

The result would be improved if pension income splitting was limited to an amount that would give Martin a Net Income of the OAS clawback income threshold as that would reduce Sally's OAS clawback without clawing back his OAS. However, that may not be the best solution. Finding the optimum solution is not an intuitive process, especially if there are other factors such as medical costs, and would require the use of tax software.

## Self Study Solution Nine - 6

### *Part A - Net Income For Tax Purposes*

The minimum Net Income For Tax Purposes that can be reported by Mr. Masters is calculated as follows:

| | | |
|---|---|---|
| Wages From Summer Employment | | 5,400 |
| Moving Costs To Pelican Lake (Note 1) | | ( 350) |
| Scholarship Received | $3,500 | |
| Exempt Portion Of Scholarship (100%) | ( 3,500) | Nil |
| Moving Costs To Winnipeg (Note 1) | | Nil |
| Eligible Dividends Received | | 2,000 |
| Gross Up Of Dividends (38 Percent) | | 760 |
| Child Support Received (Note 2) | | Nil |
| Inheritance (Not Taxable) | | Nil |
| TFSA Contributions (Note 3) | | Nil |
| TFSA Withdrawal (Note 3) | | Nil |
| Net Income For Tax Purposes | | $7,810 |

**Note 1** The cost of the move to Pelican Lake is deductible against the income that was earned there as it is more than 40 km from Winnipeg. Since there was no addition to his Net Income For Tax Purposes due to his scholarship, he cannot deduct the cost of the move back to Winnipeg.

**Note 2** While spousal support is taxable to the recipient and deductible to the payor, child support is not taxable to the recipient or deductible to the payor.

**Note 3** TFSA contributions and withdrawals have no tax consequences since the total $20,000 contributed is less than the maximum contribution allowable. There is also no income attribution as a result of the TFSA contribution by Mr. Masters' wife.

### *Part B - Registered Education Savings Plan*

Payments into an RESP are not deductible. However, no tax liability is created by the amounts earned on the assets held in the plan. Rather, the earnings of these assets will be taxed in the hands of the recipient (presumably Mr. Masters' son) when the funds are withdrawn. However, to be eligible to receive these payments, the child must be in full time or part time attendance at an institution that would qualify the child for the education tax credit.

Mr. Masters must obtain information regarding the contribution room available for the Canada Education Savings Grant (CESG). Since his parents have been contributing to the RESP, it is not possible to determine how much CESG his son has available without more information.

Given his wife's profession, it is likely the family income is far too high to qualify for the Canada Learning Bonds program. As a result, that program would have no impact on any advice related to Mr. Masterson's son's RESP.

## Self Study Solution Nine - 7

### *Part A - Case 1 - Sale To Arm's Length Party*

The result for Martin would be as follows:

| | |
|---|---|
| Proceeds Of Disposition | $500,000 |
| Adjusted Cost Base | ( 360,000) |
| Capital Gain | $140,000 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain | $ 70,000 |

With respect to the subsequent sale by the arm's length purchaser, the results for that individual would be as follows:

| | |
|---|---|
| Proceeds Of Disposition | $500,000 |
| Adjusted Cost Base | ( 500,000) |
| Capital Gain | Nil |

### *Part A - Case 2 - Sale To Sister*

The result for Martin would be as follows:

| | |
|---|---|
| Deemed Proceeds Of Disposition - ITA 69(1)(b) | $500,000 |
| Adjusted Cost Base | ( 360,000) |
| Capital Gain | $140,000 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain | $ 70,000 |

With respect to the subsequent sale by Martin's sister, the results for her would be as follows:

| | |
|---|---|
| Proceeds Of Disposition (Actual) | $500,000 |
| Adjusted Cost Base | ( 360,000) |
| Capital Gain | $140,000 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain | $ 70,000 |

Note that in this case the $140,000 capital gain is subject to double taxation.

***Part A - Case 3 - Gift To Son***

The result for Martin would be as follows:

| | |
|---|---|
| Deemed Proceeds Of Disposition - ITA 69(1)(b) | $500,000 |
| Adjusted Cost Base | ( 360,000) |
| Capital Gain | $140,000 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain | $ 70,000 |

With respect to the subsequent sale by Martin's son, the results for him would be as follows:

| | |
|---|---|
| Proceeds Of Disposition | $500,000 |
| Adjusted Cost Base (Actual) | ( 500,000) |
| Capital Gain | Nil |

The fact that his son is younger than 18 years of age does not affect the results.

***Part A - Case 4 - Sale To Mother***

The result for Martin would be as follows:

| | |
|---|---|
| Proceeds Of Disposition (Actual) | $600,000 |
| Adjusted Cost Base | ( 360,000) |
| Capital Gain | $240,000 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain | $120,000 |

With respect to the subsequent sale by Martin's mother, the results for her would be as follows:

| | |
|---|---|
| Proceeds Of Disposition (Actual) | $500,000 |
| Adjusted Cost Base - ITA 69(1)(a) | ( 500,000) |
| Capital Gain | Nil |

Despite the fact that Martin had to record the actual proceeds of $600,000, his mother's adjusted cost base will be the fair market value of $500,000. This means that she did not have a $100,000 capital loss to economically offset (for the family unit) the effect of his capital gain.

***Part B***

In Case 2, the sale was for $360,000, less than the $500,000 fair market value of the asset. Martin might agree to do this in an attempt to transfer the $140,000 gain to his sister. This could be motivated by the fact that she is in a lower tax bracket. It could also reflect the fact that she has unused capital losses that she would like to be able to use.

In Case 4, the sale was for $600,000, more than the $500,000 fair market value of the asset. The motivation here could be that his mother has capital gains that she would like to offset with a capital loss resulting from her re-selling the asset for $500,000 and/or Martin has unused capital losses greater than $140,000 that he would like to be able to use.

## Self Study Solution Nine - 8

***Scenario 1 - FMV > Transferor's Capital Cost***

The results of the disposition for Martin can be calculated as follows:

| | |
|---|---|
| UCC Balance | $36,000 |
| Lesser Of: | |
| Proceeds Of Disposition = $87,000 | |
| Capital Cost = $52,000 | ( 52,000) |
| Negative Ending UCC Balance = Recapture Of CCA | ($16,000) |

| | |
|---|---|
| Proceeds Of Disposition | $87,000 |
| Capital Cost | ( 52,000) |
| Capital Gain | $35,000 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain | $17,500 |

Martin's Net Income For Tax Purposes will increase by $33,500 ($16,000 + $17,500).

For his sister, her capital cost for capital gains purposes will be the transfer price of $87,000. However, because the fair market value of the asset exceeded its original capital cost, ITA 13(7)(e) will limit the value used for CCA and recapture calculations to the following amount:

[$52,000 + (1/2)($87,000 - $52,000)] = $69,500

***Scenario 2 - FMV < Transferor's Capital Cost***

The results of this disposition for Marion can be calculated as follows:

| | |
|---|---|
| UCC Balance | $105,000 |
| Lesser Of: | |
| Proceeds Of Disposition = $142,000 | |
| Capital Cost = $212,000 | ( 142,000) |
| Negative Ending UCC Balance = Recapture Of CCA | ($ 37,000) |

Marion's Net Income For Tax Purposes will increase by $37,000.

In this case, where the fair market value of the asset is less than its capital cost, ITA 13(7)(e) deems the transferee's capital cost of the transferred asset to be equal to the transferor's capital cost, an amount of $212,000. This capital cost will be used for purposes of determining any capital gain and/or recapture on a future disposition.

The $70,000 ($212,000 - $142,000) difference between this value and the transfer price will be considered deemed CCA. The resulting UCC balance of $142,000 will be used by Marion's brother for calculating future CCA.

## Self Study Solution Nine - 9

**Note To Student** Part B of this problem requires knowledge of ITA 13(21.1) as there is a capital gain on the land and a terminal loss on the building. This provision is covered in detail in Chapter 8.

### *Case A(1)*

Assuming that the transfer was to Margarette's spouse, the land would have been transferred at its cost and the building would have been transferred at its UCC. As a consequence, there would have been no tax effects to be included in Margarette's final return.

For CCA purposes, the building would have been transferred at Margarette's UCC of $363,000. Given this, maximum CCA would be $14,520 [(4%)($363,000)] for 2019 leaving a UCC of $348,480. Since the acquisition of the building is a non-arm's length transaction, it was used and continues to be used to produce income and was owned for more than one year by Margarette, the half year rule does not apply to Gianni.

Note, however, that after the transfer, Gianni would have retained the building's old capital cost of $473,000. Using this figure for the building, the tax effects that would occur at the time of the 2020 sale of the property would be as follows:

| | Land | Building |
|---|---|---|
| Proceeds Of Disposition | $160,000 | $525,000 |
| Adjusted Cost Base/Capital Cost | ( 150,000) | ( 473,000) |
| Capital Gain | $ 10,000 | $ 52,000 |
| Inclusion Rate | 1/2 | 1/2 |
| Taxable Capital Gain | $ 5,000 | $ 26,000 |

| | |
|---|---|
| UCC | $348,480 |
| Deduct Disposition - Lesser Of: | |
| • Capital Cost = $473,000 | |
| • Proceeds Of Disposition = $525,000 | ( 473,000) |
| Negative Closing UCC Balance = Recaptured CCA | ($124,520) |

A total of $155,520 ($5,000 + $26,000 + $124,520) would be added to the 2020 Net Income For Tax Purposes of Gianni. With the death of Margarette, there can be no income or capital gains attributed to her from Gianni.

### *Case A(2)*

As the transfer was to her daughter, Ciara, the deemed proceeds will be recorded at fair market value for the land and building. Based on this, the following calculations show the tax effects that will be included in Margarette's final return:

| | Land | Building |
|---|---|---|
| Deemed Proceeds | $175,000 | $571,000 |
| Adjusted Cost Base/Capital Cost | ( 150,000) | ( 473,000) |
| Capital Gain | $ 25,000 | $ 98,000 |
| Inclusion Rate | 1/2 | 1/2 |
| Taxable Capital Gain | $ 12,500 | $ 49,000 |

| | |
|---|---|
| UCC Of Building | $363,000 |
| Deduct Disposition - Lesser Of: | |
| • Capital Cost = $473,000 | |
| • Deemed Proceeds = $571,000 | ( 473,000) |
| Negative Closing UCC Balance = Recaptured CCA | ($110,000) |

A total of $171,500 ($12,500 + $49,000 + $110,000) would be added to Margarette's 2019 Net Income For Tax Purposes.

With respect to Ciara's tax records, the land will have a tax cost of $175,000 and the building will be a Class 1 asset with a tax cost equal to Margarette's deemed proceeds of $571,000.

Maximum 2019 CCA is $22,840 [($571,000)(4%)], leaving a UCC of $548,160 ($571,000 - $22,840). Since the acquisition of the building is a non-arm's length transaction, it was used and continues to be used to produce income and was owned for more than one year by Margarette, the half year rule does not apply to Ciara. In addition, ITA 13(7)(e), which requires the calculation of a limited UCC balance, is not applicable to transfers at death.

Since there cannot be a capital loss on depreciable property and the building is the only asset in the class, the 2020 tax effects associated with the sale of the building would be calculated as follows:

| | Land | Building |
|---|---|---|
| Proceeds Of Disposition | $160,000 | $525,000 |
| Adjusted Cost Base | ( 175,000) | |
| Capital Cost Limited To Proceeds | | ( 525,000) |
| Capital Gain (Loss) | ($ 15,000) | Nil |
| Inclusion Rate | 1/2 | N/A |
| Allowable Capital Loss | ($ 7,500) | Nil |

| | |
|---|---|
| UCC | $548,160 |
| Deduct Disposition - Lesser Of: | |
| • Capital Cost = $571,000 | |
| • Proceeds Of Disposition= $525,000 | ( 525,000) |
| Positive Closing UCC Balance = Terminal Loss | $ 23,160 |

A total of $30,660 ($23,160 + $7,500) would be deducted from the 2020 Net Income For Tax Purposes of Ciara as the problem indicates that she has sufficient income and taxable capital gains.

### *Comparison Case A(1) And A(2)*

The overall tax consequences in the two cases are as shown in the following table:

| | Case A(1) Gianni | Case A(2) Margarette | Case A(2) Ciara |
|---|---|---|---|
| 2019 | Nil | $171,500 | Nil |
| 2019 - CCA Taken | ($ 14,520) | | ($22,840) |
| 2020 | 155,520 | | ( 30,660) |
| Net Income For Tax Purposes (Loss) | $141,000 | $171,500 | ($53,500) |

There is a difference in the Case A(1) and Case A(2) results of $23,000 [$141,000 - ($171,500 - $53,500)]. This reflects the fact that, in Case A(2), a portion of the amount that was taxed as a capital gain (50 percent) in Margarette's final return was deducted by Ciara as CCA and a terminal loss (100 percent).

This can be shown in the following calculation:

| | |
|---|---|
| Actual Sale Price Of Building For Ciara | $525,000 |
| Fair Market Value (Deemed Proceeds) At Death | ( 571,000) |
| Amount Deducted By Ciara As CCA And Terminal Loss* | ($ 46,000) |
| Portion Taxed As Capital Gain In Final Return [(1/2)($46,000)] | 23,000 |
| Difference | ($ 23,000) |

*$23,160 + $22,840 = $46,000

### Part B

If the proceeds of the sale of the property by Ciara were allocated $300,000 to the land and $385,000 to the building, the tax effects associated with the sale of the building would be initially calculated as follows:

| | Land | Building |
|---|---|---|
| Proceeds Of Disposition | $300,000 | $385,000 |
| Adjusted Cost Base | ( 175,000) | |
| Capital Cost Limited To Proceeds | | ( 385,000) |
| Capital Gain | $125,000 | Nil |
| Inclusion Rate | 1/2 | 1/2 |
| Taxable Capital Gain | $ 62,500 | Nil |

| | |
|---|---|
| UCC | $548,160 |
| Deduct Disposition - Lesser Of: | |
| • Capital Cost = $571,000 | |
| • Proceeds Of Disposition= $385,000 | ( 385,000) |
| Positive Closing UCC Balance = Terminal Loss | $163,160 |

Since there is a capital gain on the land and a terminal loss on the building, ITA 13(21.1)(a) requires the deemed proceeds of disposition for the building to be determined as follows:

The Lesser Of:

| | | |
|---|---|---|
| • The FMV of the land and building | $685,000 | |
| Reduced By The Lesser Of: | | |
| • The ACB of the land = $175,000 | | |
| • The FMV of the land = $300,000 | ( 175,000) | $510,000 |
| • The Greater Of: | | |
| • The FMV of the building = $385,000 | | |
| • The Lesser Of: | | |
| The cost of the building = $571,000 | | |
| The UCC of the building = $548,160 | | $548,160 |

The proceeds that would be allocated to the building would be $510,000, leaving $175,000 ($685,000 - $510,000) to be allocated to the land. The net result is that the terminal loss would be reduced by $125,000 (the amount of the potential capital gain) to $38,160 ($510,000 - $548,160) and the capital gain would be nil ($175,000 - $175,000).

## Self Study Solution Nine - 10

### Alonso

#### *At Transfer*

As Alonso did not elect out of the ITA 73(1) spousal rollover, no income will result from the transfer to his spouse Alice. However, there is no rollover for the transfer of public company shares to a related minor. This means there will be a taxable capital gain on the transfer of 10,000 shares to his son as follows:

| | |
|---|---|
| Deemed Proceeds Of Disposition [($17.00)(10,000)] | $170,000 |
| Adjusted Cost Base [($12.50)(10,000)] | ( 125,000) |
| Capital Gain | $ 45,000 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain | $ 22,500 |

#### *Dividends*

As all of the shares were given to a spouse and a related minor, 100 percent of the dividends would be attributed back to Alonso. His increase in Net Income For Tax Purposes due to the dividends would be $16,560 [(15,000)(138%)($0.80)].

#### *Sale Of Shares*

As there is no attribution of capital gains when shares are transferred to a related minor, the sale of shares by Alonso's son would have no effect on Alonso's 2019 Net Income For Tax Purposes. However, the gain on the sale of shares by his spouse would be attributed back to Alonso. The amount is calculated as follows:

| | |
|---|---|
| Proceeds Of Disposition [($16.00)(5,000)] | $80,000 |
| Adjusted Cost Base [($12.50)(5,000)] | ( 62,500) |
| Capital Gain | $17,500 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain | $8,750 |

### Alice

None of these transactions would have any effect on Alice's 2019 Income For Tax Purposes.

### Alonso Jr.

When Alonso Jr. sells his Lisgar Inc. shares, he will have an allowable capital loss calculated as follows:

| | |
|---|---|
| Proceeds Of Disposition [($16.00)(10,000)] | $160,000 |
| Adjusted Cost Base [($17.00)(10,000)] | ( 170,000) |
| Capital Loss | ($ 10,000) |
| Inclusion Rate | 1/2 |
| Allowable Capital Loss | ($ 5,000) |

This loss can only be deducted in 2019 to the extent that Alonso Jr. has taxable capital gains during 2019. As a result, the sale will not affect Net Income For Tax Purposes unless he has taxable capital gains.

# Self Study Solution Nine - 11

## Note

As the farm would be considered qualified farm property, any capital gains arising from a disposition could be eligible for the lifetime capital gains deduction. If Long Consulting Ltd. is a qualified small business corporation, capital gains on the disposition of these shares could also be eligible for the lifetime capital gains deduction. As this deduction is not discussed until Chapter 11, the problem specifies that these possibilities should be ignored.

## Long Consulting Ltd.

### *1. Gift To Spouse - ITA 73(1) Applies*

ITA 73(1) permits transfers of a capital property to a spouse at its tax value (adjusted cost base or UCC). This means that the shares in Long Consulting Ltd. could be gifted to Mr. Long with no immediate tax consequences.

The tax basis for these shares for the spouse would remain at the adjusted cost base of $210,000.

Any dividends paid on the shares would be attributed to Mrs. Long.

If Mr. Long subsequently sell these shares for $525,000 ($50,000 more than the $475,000 fair market value at the time of the gift), the resulting taxable capital gain of $157,500, as calculated in the following table, would also be attributed to Mrs. Long.

| | |
|---|---|
| Proceeds (Fair Market Value) | $525,000 |
| Adjusted Cost Base | ( 210,000) |
| Capital Gain | $315,000 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain | $157,500 |

### *2. Gift To Spouse - Elect Out Of ITA 73(1)*

As an alternative, Mrs. Long could elect out of the provisions of ITA 73(1). Under ITA 69, the gift would be recorded as a disposition at the $475,000 fair market value. Mrs. Long would have an immediate taxable capital gain of $132,500 [(1/2)($475,000 - $210,000)] and Mr. Long's adjusted cost base would be $475,000. However, since the transfer is a gift, and Mr. Long does not use his own funds to purchase the shares, income attribution would apply to any dividends received by Mr. Long. In addition, if the property was subsequently sold by Mr. Long for $525,000, the resulting taxable capital gain of $25,000 [(1/2)(525,000 - $475,000)] would be attributed back to Mrs. Long.

### *3 And 4. Gift To Children*

Under ITA 69, a gift to a related party is deemed to be a transfer at fair market value. Given this, a taxable capital gain of $132,500 [(1/2)($475,000 - $210,000) would result from a transfer to either child. The adjusted cost base to the children would be the fair market value of $475,000.

Under the general income attribution rules, the dividend income paid on the shares given to Mary, who is under 18, would be attributed back to Mrs. Long. The problem specifies that the tax on split income should be ignored. However, as is discussed in Chapter 11, this dividend income would be subject to the tax on split income and, because of this, it would be exempt from the general income attribution rules.

As Barry is over 18, the gift would not result in attribution of dividends.

There is no attribution of capital gains on assets transferred to children, without regard to their age. This means that, if the property was later sold for $525,000, the resulting taxable capital gain of $25,000 would be taxed in the hands of the child who received the gift.

## Rental Property

### 1. Gift To Spouse - ITA 73(1) Applies

Here again, ITA 73(1) would permit a transfer to Mr. Long at tax values with no immediate tax consequences.

The tax cost of the building to Mr. Long would be the UCC of $125,000. However, Mr. Long would retain the capital cost of $190,000. With respect to the land, its adjusted cost base would be $100,000. This was Mrs. Long's tax cost and the current fair market value of the land.

As the transfer is a gift, income attribution rules would apply. This means that any net rental income would be attributed to Mrs. Long.

If Mr. Long were to later sell the building for $325,000 ($50,000 more than its fair market value at the time of the gift), the following amounts would be attributed to Mrs. Long:

| | |
|---|---|
| Capital Cost | $190,000 |
| UCC | ( 125,000) |
| Recaptured CCA | $ 65,000 |

| | |
|---|---|
| Proceeds Of Disposition | $325,000 |
| Adjusted Cost Base | ( 190,000) |
| Capital Gain | $135,000 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain | $ 67,500 |

Since we are assuming the value of the land on which the building was situated has not changed, the sale of the land by Mr. Long would have no tax consequences for Mrs. Long. As you are asked to assume that no CCA is taken between the date of the gift and the date the property is sold, there would be no recapture of CCA resulting from the sale.

### 2. Gift To Spouse - Elect Out Of ITA 73(1)

Mrs. Long could also elect out of the provisions of ITA 73(1) and transfer the rental property at its fair market value. However, if she does, she would immediately be taxed on the recapture of $65,000, as well as the taxable capital gain of $42,500 [(1/2)($275,000 - $190,000)]. There would be no tax consequences related to the land as its tax cost is equal to its fair market value.

In this case, the cost of the building to Mr. Long for capital gains purposes would be $275,000. For CCA and recapture purposes, the value would be limited to $232,500 [$190,000 + (1/2)($275,000 - $190,000)]. His cost for the land would be $100,000.

Electing out of ITA 73(1) would not change the fact that the transfer is a gift to a spouse and, as a consequence, future rental income would be attributed to Mrs. Long.

If Mr. Long subsequently sells the building for $325,000, the additional taxable capital gain of $25,000 [(1/2)($325,000 - $275,000)] would also be attributed back to Mrs. Long. As we are assuming the value of the land remains at $100,000 and that no CCA is taken prior to the sale, there are no tax consequences associated with its sale.

### 3 And 4. Gift To Children

There is no exemption from the general rules of ITA 69 for transfers of depreciable property to children. As a consequence, Mrs. Long would be subject to taxation based on a disposition of the property at its fair market value of $275,000. This would result in immediate taxation on a $42,500 [(1/2)($275,000 - $190,000)] taxable capital gain, as well as on recapture of $65,000 ($190,000 - $125,000). There would be no tax consequences related to the land as its tax cost is equal to its fair market value.

The cost of the building to either of the children for capital gains purposes would be \$275,000. The cost for the land would be \$100,000. For CCA and recapture purposes, the value would be limited to \$232,500 [\$190,000 + (1/2)(\$275,000 - \$190,000)].

If this property was given to Mary, the income attribution rules of ITA 74.1 would apply to any amount of property income subsequently earned. This would mean that until Mary reached 18 years of age, any property income from the rental property would be attributed to Mrs. Long. Alternatively, if the property was gifted to her son, Barry, all subsequent income would be taxed in his hands.

There is no attribution of capital gains on gifts to related children under 18. There would be no attribution of capital gains on a gift to either child. This means that if the property were later sold for \$325,000 (\$275,000 + \$50,000), the \$25,000 taxable capital gain would be taxed in the hands of the child who received the gift. As noted in the discussion of the alternative gift recipients, there would be no recapture of CCA resulting from the sale.

## Dynamics Inc.

### *1. Gift To Spouse - ITA 73(1) Applies*

As with the other properties, these shares could be given to Mr. Long and, under the provisions of ITA 73(1), no immediate tax consequences would arise.

The tax basis for Mr. Long would be unchanged at \$212,000.

Any dividend income on the shares would be attributed to Mrs. Long.

If Mr. Long were to subsequently sell the shares for \$434,000 (\$50,000 more that their \$384,000 fair market value at the time of the gift), the income attribution rules of ITA 74.1 would require that the following taxable capital gain be attributed to the income of Mrs. Long:

| | |
|---|---|
| Proceeds Of Disposition | \$434,000 |
| Adjusted Cost Base | ( 212,000) |
| Capital Gain | \$222,000 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain | \$111,000 |

### *2. Gift To Spouse - Elect Out Of ITA 73(1)*

Mrs. Long could elect out of ITA 73(1) by recording the \$86,000 [(1/2)(\$384,000 - \$212,000)] taxable capital gain at the time of the transfer to her spouse.

In this case the adjusted cost base to Mr. Long would be \$384,000.

However, as long as the property was transferred as a gift, attribution would apply to both dividend income received by Mr. Long and to any further capital gains realized on a subsequent sale. If the property was subsequently sold for \$434,000, Mr. Long would have a taxable capital gain of \$25,000 [(1/2)(\$434,000 - \$384,000)] that would be attributed back to Mrs. Long.

### *3 And 4. Gift To Children*

In the case of a transfer to either of her children, ITA 69 would require that the gift be treated as a deemed disposition with the proceeds at the fair market value of \$384,000. This would result in an immediate taxable capital gain of \$86,000 [(1/2)(\$384,000 - \$212,000)]

The tax base to the children would be the fair market value of \$384,000.

A transfer to Mary would result in the application of the income attribution rules of ITA 74.1. This would mean that subsequent dividend income on these shares would be allocated to Mrs. Long until Mary reaches 18 years of age. If the shares were transferred to Barry, there would be no attribution of dividends.

There is no attribution of capital gains on assets transferred to children, without regard to their age. This means that, if the property was later sold for $434,000, the resulting taxable capital gain of $25,000 [(1/2)($434,000 - $384,000)] would be taxed in the hands of the child who received the gift.

## Farm Land

### 1. Gift To Spouse - ITA 73(1) Applies

As with all of the other properties, Mrs. Long could make a tax free transfer of the farm land to her husband under ITA 73(1).

The adjusted cost base to Mr. Long would remain unchanged at $80,000.

As farm income is considered to be business income rather than property income, there would be no attribution of any farm income that arises while Mr. Long is holding the property.

In the event of a subsequent sale of the farm land for $225,000 ($50,000 more than the fair market value at the time of transfer), the following taxable capital gain would be attributed to Mrs. Long under ITA 74.1:

| | |
|---|---|
| Proceeds Of Disposition | $225,000 |
| Adjusted Cost Base | ( 80,000) |
| Capital Gain | $145,000 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain | $ 72,500 |

### 2. Gift To Spouse - Elect Out Of ITA 73(1)

Alternatively, Mrs. Long could elect out of ITA 73(1) and transfer the property at its fair market value of $175,000. This would result in an immediate taxable capital gain of $47,500 [(1/2)($175,000 - $80,000)].

In this case the adjusted cost base to Mr. Long would be $175,000.

A noted, farm income is business income and this would not be attributed to Mrs. Long

As the transfer was a gift, the income attribution rules would apply to subsequent capital gains on the property. If Mr. Long sells the property for $225,000, the resulting $25,000 [(1/2)($225,000 - $175,000)] taxable capital gain would be attributed back to Mrs. Long.

### 3 And 4. Gift To Children

ITA 73(3) permits the inter vivos transfer of farm property used by the taxpayer or her family to a child on a tax free basis. The deemed proceeds would be Mrs. Long's adjusted cost base, which means that Mrs. Long would incur no taxation at the time of the gift to either child.

The adjusted cost base to either child would be the same $80,000 that was deemed to be the proceeds of the disposition.

As noted in our discussion of the transfer of this property to Mr. Long, because farm income is business income rather than property income, there will be no attribution of farm income in the case of a transfer to either child.

On most transfers to related minors, there is no attribution of capital gains. This is a reflection of the fact that, unlike the rules for transfers to a spouse, there is no general rollover provision for transfers to related minors on a tax free basis. However, when a transfer is made to a related minor under the provisions of ITA 73(3) and the transfer value is below fair market value, ITA 75.1 requires that any subsequent gain resulting from a disposition by the transferee before they reach age 18 be attributed back to the transferor.

This means that, if the farm property is transferred to Mary and she sells the property for $225,000 before she reaches age 18, a taxable capital gain of $72,500 [(1/2)($225,000 - $80,000)] will be attributed to Mrs. Long. If the transfer was to Barry, this capital gain would not be attributed to Mrs. Long and would be taxed in his hands.

## Self Study Solution Nine - 12

### *Net Employment Income*

Carolyn's employment income would be calculated as follows:

| | |
|---|---|
| Salary [(10 Months)($5,000)] | $50,000 |
| RPP Contributions (Note 1) | ( 2,600) |
| Automobile (Note 2) | 6,047 |
| Travel Allowance (Note 3) | Nil |
| Moving Cost Allowance | 10,000 |
| Housing Loss Reimbursement (Note 4) | Nil |
| Housing Cost Allowance (Note 5) | 7,500 |
| Net Employment Income | $70,947 |

**Note 1** While Carolyn's RPP contributions can be deducted, the matching contribution by her employer does not create a taxable benefit.

**Note 2** The automobile benefit would be calculated as follows:

| | |
|---|---|
| Standby Charge [(2%)($42,000)(9)(8,000 ÷ 15,003*)] | $4,031 |
| Operating Cost Benefit - Lesser Of: | |
| • [(1/2)($4,031)] = $2,016 | |
| • [(8,000)($0.28)] = $2,240 | 2,016 |
| Total Benefit | $6,047 |

* [(9)(1,667)]

**Note 3** As the allowance appears to be reasonable, it does not have to be included in income. Given this, Carolyn cannot deduct her actual costs.

**Note 4** As the housing loss reimbursement is less than $15,000, it does not have to be included in income.

**Note 5** Assistance with higher housing costs related to a required move must be included in an employee's income.

### *Property Income*

Carolyn's property income is calculated as follows:

| | |
|---|---|
| Eligible Dividends Received | $ 5,800 |
| Gross Up At 38 Percent | 2,204 |
| Recapture On Rental Property (Note 6) | 20,000 |
| Total Property Income | $28,004 |

**Note 6** The fair market value of the rental building when it is bequeathed to Carolyn is $270,000 ($320,000 - $50,000). While this would be the UCC value that Carolyn would use to calculate CCA, because the fair market value of the property at the time of transfer is less than its capital cost, Carolyn must use her mother's capital cost of $300,000 ($400,000 - $100,000).

Carolyn's proceeds from the sale of the building is $290,000 ($340,000 - $50,000) and, when she subtracts the lesser of the capital cost ($300,000) and the proceeds ($290,000) from the $270,000 UCC, the result is recapture of $20,000 ($270,000 - $290,000).

### Taxable Capital Gains

Carolyn's only capital gains will arise on the sale of the shares that were gifted to her by her father. Note that her adjusted cost base for these shares will be their fair market value at the time of the gift.

| | |
|---|---|
| Proceeds Of Disposition | $74,000 |
| Adjusted Cost Base | ( 62,000) |
| Capital Gain | $12,000 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain | $ 6,000 |

### Other Income And Deductions

Carolyn's other income and other deductions amount is calculated as follows:

| | |
|---|---|
| Spousal Support (Note 7) | $ 500 |
| Moving Costs (Note 8) | ( 27,944) |
| Child Care Cost (Note 9) | ( 7,300) |
| Total Other Income And Deductions | ($34,744) |

**Note 7** When the full amount of support is not paid, the first payments are deemed to be for child support. Given the total payments of $12,500 and the required child support of $12,000 [(12)($1,000)], Carolyn will include only $500 in her Net Income For Tax Purposes.

**Note 8** Costs for food and lodging at or near an old or new residence are limited to a maximum period of 15 days. Carolyn has a total of 23 eligible days: 14 days in Lethbridge and 9 days in Edmonton. Note that the 2 days spent travelling to Edmonton are not included in the 15 day total. As the hotel in Edmonton is the more expensive, she will deduct all 9 days spent there. Carolyn's deductible moving costs can be calculated as follows:

| | |
|---|---|
| Selling Cost Of Lethbridge Property | $12,500 |
| Legal Fees - Sale Of Lethbridge Property | 600 |
| Legal Fees - Purchase Of Edmonton Property | 450 |
| Storage Costs - February 15 Through March 10 | 1,400 |
| Cost Of Moving Belongings | 7,250 |
| Lodging In Lethbridge And Edmonton (9 @ $200 + 6 @$175) | 2,850 |
| Simplified Meal Cost [(3)($51)(15 + 2 Days)] | 2,601 |
| Simplified Milage [($.58)(506)] | 293 |
| Total Deductible Moving Costs | $27,944 |

As this amount is less than her income at her new job, she will be able to deduct the full amount of these expenses.

**Note 9** Carolyn's deductible care costs would be the least of three amounts:

| | | |
|---|---|---|
| Actual Costs Plus Deductible Camp Costs | | |
| Edmonton Cost [(38)(($175)] | $6,650 | |
| Camp [(2)($200 + $125)] | 650 | $ 7,300 |
| Annual Limit ($8,000 + $5,000) | | $13,000 |
| Two-Thirds Earned Income [(2/3)($70,947 + $2,600 RPP)] | | $49,031 |

The least of these three amounts is the actual cost of $7,300.

### Net Income For Tax Purposes

Carolyn's Net Income For Tax Purposes would be determined as follows:

| | |
|---|---|
| Net Employment Income | $70,947 |
| Property Income | 28,004 |
| Taxable Capital Gains | 6,000 |
| Other Income And Deductions | ( 34,744) |
| Net Income For Tax Purposes | $70,207 |

### Taxable Income

As Carolyn has no Division C deductions, her Taxable Income would be equal to her Net Income For Tax Purposes.

### Tax Payable

Carolyn's Tax Payable would be determined as follows:

| | | |
|---|---|---|
| Tax On First $47,630 | | $ 7,145 |
| Tax On Next $22,577 ($70,207 - $47,630) At 20.5 Percent | | 4,628 |
| Tax Before Credits | | $11,773 |
| Tax Credits: | | |
| Basic Personal | ($12,069) | |
| Eligible Dependant | ( 12,069) | |
| EI Premiums | ( 860) | |
| CPP Contributions | ( 2,749) | |
| Canada Employment | ( 1,222) | |
| Medical Expenses (Note 10) | ( 5,494) | |
| Total Credit Base | ($34,463) | |
| Rate | 15% | ( 5,169) |
| Dividend Tax Credit [(6/11)($2,204)] | | ( 1,202) |
| Charitable Donations (Note 11) [(15%)($200) + (29%)($600 - $200)] | | ( 146) |
| Federal Tax Payable | | $ 5,256 |

**Note 10** The medical expenses eligible for the credit are as follows:

| | |
|---|---|
| Total Medical Costs | $7,600 |
| Lesser Of: | |
| • $2,106 [(3%)($70,207)] | |
| • 2019 Threshold Amount = $2,352 | ( 2,106) |
| Medical Expense Tax Credit Base | $5,494 |

**Note 11** As none of her income is taxed at 33 percent, this rate will not be applicable to the calculation of the charitable donations tax credit.

## Self Study Solution Nine - 13

***Part A - Net Income For Tax Purposes And Taxable Income For Mr. Winded***

The Net Income For Tax Purposes for Mr. Winded would be calculated as follows:

| | | | |
|---|---|---|---|
| **Net Employment Income** | | | |
| Salary [($84,000)(2/12)] | | $14,000 | |
| Standby Charge [(2/3)($360)(2)] | | 480 | |
| Operating Cost Benefit [(90%)(3,000)($0.28)] | | | |
| (Alternate calculation not available) | | 756 | |
| Taxable Portion Of Gift ($700 - $500) | | 200 | |
| Stock Option Benefit [(1,500)($11 - $8)] | | 4,500 | |
| RPP Contributions | | ( 500) | $ 19,436 |
| **Net Business Income** (Note 1) | | | 15,805 |
| **Property Income** | | | |
| Interest Income | | $ 3,478 | |
| Eligible Dividends Received | | 1,700 | |
| Eligible Dividends Attributed From Mrs. Winded | | 1,400 | |
| Gross Up [(38%)($1,700 + $1,400)] | | 1,178 | |
| Non-Eligible Dividends Received From Sail | | 800 | |
| Gross Up [(15%)($800)] | | 120 | |
| Net Rental Income (Note 2) | | Nil | 8,676 |
| **Net Taxable Capital Gains** | | | |
| TCG On Sale Of Celebrate Ltd. Shares | | | |
| [(1/2)(1,000)($17 – $11)] | | $ 3,000 | |
| Attributed TCG On Sale Of Preferred Shares | | | |
| [(1/2)(($31,000 - $27,000)] | | 2,000 | |
| TCG On Listed Personal Property | | | |
| Stamps ($5,000 – $8,000) | ($3,000) | | |
| Rare Book ($4,200 – $1,000) | 3,200 | | |
| Painting ($1,000 – $1,000) | Nil | | |
| | $ 200 | | |
| Inclusion Rate | 1/2 | 100 | |
| Loss On Furniture (PUP) Of $3,800 | | | |
| ($4,800 - $1,000 Floor) Not Deductible | | Nil | |
| TCG On Sale Of Sail Shares | | | |
| [(1/2)($48,000 – $12,000)] | | 18,000 | |
| TCG On Sale Of CNR Shares (Note 3) | | 1,230 | |
| ACL On Sale Of BCE Shares (Note 4) | | ( 400) | |
| TCG On Sale Of Cottage (Note 5) | | 50,000 | 73,930 |
| **Other Income And Deductions** | | | |
| Old Age Security | | $ 5,350 | |
| CPP Receipts | | 9,600 | |
| Pension Income From Celebrate Ltd. Pension Plan | | 44,000 | |
| RRIF Withdrawal | | 8,000 | |
| Moving Expenses (Note 6) | | ( 23,000) | |
| Pension Income Transferred To Spouse | | | |
| [(1/2)($44,000 + $8,000)] | | ( 26,000) | 17,950 |
| Net Income Before Clawback | | | $135,797 |
| OAS Clawback - Lesser Of: | | | |
| • Amount Received = $5,350 | | | |
| • $8,733 [(15%)($135,797 - $77,580)] | | | ( 5,350) |
| Net Income For Tax Purposes - Mr. Winded | | | $130,447 |

**Note 1** Net Business Income would be calculated as follows:

| | | |
|---|---|---|
| Revenues | | $38,000 |
| Expenses: | | |
| Supplies | | ( 16,000) |
| Advertising | | ( 1,000) |
| Home Office Costs (See Following Calculation) | | ( 3,060) |
| CCA | | |
| Class 50 [(55%)(1/2)($3,800)] | ($1,045) | |
| Class 8 | | |
| {[20%][$2,400 + (1/2)($1,600)]} | ( 640) | |
| Class 12 [(100%)($450)]* | ( 450) | ( 2,135) |
| Net Business Income | | $15,805 |

* As the two hand tools cost a total of $450, each must have cost less than $500. As a result, the first year one-half rule is not applicable.

The deductible home office costs can be calculated as follows:

| | |
|---|---|
| Mortgage Interest | $ 4,000 |
| Utilities | 3,600 |
| Property Taxes | 4,500 |
| Insurance | 1,400 |
| Maintenance | 1,800 |
| Total | $15,300 |
| Floor Space Used | 20% |
| Deductible Amount | $ 3,060 |

**Note 2** Net Rental Income would be calculated as follows:

| | Property A | Property B | Total |
|---|---|---|---|
| Rental Revenues | $ 98,000 | $62,000 | $160,000 |
| Operating Expenses | ( 104,000) | ( 54,000) | ( 158,000) |
| Income (Loss) Before CCA | ($ 6,000) | $ 8,000 | $ 2,000 |
| Class 8 CCA* | | | ( 2,000) |
| Net Rental Income | | | Nil |

*Maximum CCA on Class 8 would have been $5,600 [(20%)($12,000 + $16,000)]. However, the actual deduction is limited to the amount that would reduce the Net Rental Income to nil. Note that the CCA was claimed on Class 8 in order to preserve the Class 1 UCC balances. This will result in a lower amount of recapture when the buildings are sold. The Class 8 assets would likely have little or no proceeds of disposition when they are disposed of. This means that recapture on these assets would be unlikely.

**Note 3** - The taxable capital gain on the sale of CNR shares would be calculated as follows:

| | |
|---|---|
| Proceeds Of Disposition [($67.00)(300)] | $20,100 |
| Adjusted Cost Base [($58.80*)(300)] | ( 17,640) |
| Capital Gain | $ 2,460 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain | $ 1,230 |

*The average cost of these shares would be calculated as follows:

| | Shares | Total | Per Share |
|---|---|---|---|
| May 1, 2015 Purchase At $52 | 200 | $10,400 | |
| May 1, 2016 Purchase At $46 | 300 | 13,800 | |
| Balance | 500 | $24,200 | $48.40 |
| May 1, 2017 Sale At Cost Of $48.40 ($24,200 ÷ 500) | (400) | ( 19,360) | |
| Balance | 100 | $ 4,840 | $48.40 |
| May 1, 2018 Purchase At $64 | 200 | 12,800 | |
| Balance | 300 | $17,640 | $58.80 |

**Note 4** The allowable capital loss on the sale of BCE shares would be calculated as follows:

| | |
|---|---|
| Proceeds Of Disposition [(1,000)($36)] | $36,000 |
| Adjusted Cost Base [(1,000)($38)] | ( 38,000) |
| Capital Loss | ($ 2,000) |
| Capital Loss Per Share ($2,000 ÷ 1,000) | $2 Loss/Share |

As 600 of the shares were reacquired within 30 days of the sale, with respect to these 600 shares, the capital loss is considered a superficial loss and is disallowed. This will leave an allowable capital loss of $400 [(1/2)($2)(400)]. The remaining capital loss of $1,200 [($2)(600)] will be added to the adjusted cost base of the 600 reacquired shares.

**Note 5** The taxable capital gain on the sale of the cottage would be calculated as follows:

| | Winnipeg Home | Lake Winnipeg Cottage |
|---|---|---|
| Proceeds Of Disposition | $313,000 | $290,000 |
| Selling Costs | ( 13,000) | ( 10,000) |
| Adjusted Cost Base | ( 140,000) | ( 80,000) |
| Capital Gain | $160,000 | $200,000 |
| Exempt Portion | | |
| Home [($160,000)(9+1)] ÷ 10] | ( 160,000) | |
| Cottage [($200,000)(7+ 1)] ÷ 16] | | ( 100,000) |
| Capital Gain | Nil | $100,000 |
| Inclusion Rate | | 1/2 |
| Taxable Capital Gain | Nil | $ 50,000 |

* The costs of selling a previously occupied residence that was ordinarily inhabited can be deducted as part of moving expenses. There is no restriction on claiming the selling costs to both reduce the capital gain on the old residence and also to increase moving expenses.

The annual gain on the two properties is as follows:

- Winnipeg Home ($160,000 ÷ 10) = $16,000
- Lake Winnipeg Cottage ($200,000 ÷ 16) = $12,500

Given this, maximum available years should be allocated to the Winnipeg property. These would be the 9 years 2010 through 2019. This would leave the 7 years 2004 through 2010 for the cottage.

**Note 6** As there is no income in the Vancouver location during 2018, the moving expenses incurred in that year will have to be deducted in 2019. None of the costs of the house hunting trip are deductible. The eligible moving expenses that were incurred in 2018 and 2019 are as follows:

| | |
|---|---|
| Legal Fees - Purchase Of New Home | $ 4,800 |
| January Air Fare | 1,200 |
| Selling Costs - Sale Of Old Home | 13,000 |
| Transport Of Household Effects | 4,000 |
| Total Available Moving Expenses | $23,000 |

These expenses can only be deducted to the extent of employment and business income earned during 2019. As these two amounts total $35,241 ($19,436 + $15,805), the full amount of eligible expenses can be deducted.

### *Part A - Taxable Income For Mr. Winded*

Taxable Income for Mr. Winded would be calculated as follows:

| | |
|---|---|
| Net Income For Tax Purposes | $130,447 |
| Stock Option Deduction [($4,500)(1/2)] | ( 2,250) |
| Taxable Income - Mr. Winded | $128,197 |

### *Part A - Net Income For Tax Purposes And Taxable Income For Mrs. Winded*

Mrs. Winded has no Taxable Income deductions. This means that her Taxable Income is equal to her Net Income For Tax Purposes which would be calculated as follows:

| | |
|---|---|
| Old Age Security | $ 7,400 |
| Canada Pension Plan | 3,100 |
| Transferred Pension Income | 26,000 |
| Dividends (Attributed Back To Mr. Winded) | Nil |
| Net Income For Tax Purposes = Taxable Income - Mrs. Winded | $36,500 |

### *Part B - Federal Balance Owing (Tax Payable) For Mrs. Winded*

While the medical expenses can be claimed by either spouse, they are claimed on Mrs. Winded's return as she has the lower Net Income For Tax Purposes. This results in a lesser reduction of the medical expenses claimed in the computation of the credit. She does have sufficient Tax Payable to fully utilize the credit.

Mrs. Winded's federal Tax Payable would be calculated as follows:

| | | |
|---|---|---|
| Tax Before Credits [(15%)($36,500)] | | $5,475 |
| Tax Credits: | | |
| Basic | ($12,069) | |
| Age (Note 7) | ( 7,494) | |
| Disability | ( 8,416) | |
| Pension Amount | ( 2,000) | |
| Medical Expenses (Note 8) | ( 2,455) | |
| Total Credit Base | $32,434 | |
| Rate | 15% | ( 4,865) |
| Federal Tax Payable | | $ 610 |

**Note 7** Rachel's income is below the income threshold for the age credit. This means the full age amount is available to her.

**Note 8** The base for the medical expense credit is calculated as follows:

| | |
|---|---|
| Total Medical Expenses ($150 + $4,600 - $1,200) | $3,550 |
| Reduced By The Lesser Of: | |
| • [(3%)($36,500)] = $1,095 | |
| • 2019 Threshold Amount = $2,352 | ( 1,095) |
| Base For Medical Expense Credit | $2,455 |

### *Part B - Federal Tax Payable For Mr. Winded*

As Mrs. Winded has fully utilized her credits, there are none to be transferred to Mr. Winded. The Federal Balance Owing for Mr. Winded would be calculated as follows:

| | | |
|---|---|---|
| Tax On First $95,259 | | $16,908 |
| Tax On Next $32,938 ($128,197 - $95,259) At 26 Percent | | 8,564 |
| Tax Before Credits | | $25,472 |
| Tax Credits | | |
| Basic | ($12,069) | |
| Spousal (Income Exceeds $14,299) | Nil | |
| Age (Income Exceeds $87,750) | Nil | |
| Pension Amount | ( 2,000) | |
| CPP | ( 700) | |
| EI | ( 200) | |
| Canada Employment | ( 1,222) | |
| Total Credit Base | ($16,191) | |
| Rate | 15% | ( 2,429) |
| Charitable Donations (Note 9) | | |
| [(15%)($200) + (29%)($3,700 - $200)] | | ( 1,045) |
| Dividend Tax Credits | | |
| Eligible Dividends [(6/11)($1,178)] | | ( 643) |
| Sail Ltd. Dividends [(9/13)($120)] | | ( 83) |
| Federal Tax Payable | | $21,272 |
| OAS Repayment | | 5,350 |
| Total Balance Owing | | $26,622 |

**Note 9** As none of his income is taxed at 33 percent, this rate will not be applicable to the calculation of the charitable donations tax credit.

## Chapter 9 Learning Objectives

After completing Chapter 9, you should be able to:

1. Identify the major other sources of income that are listed under Subdivision d of the *Income Tax Act* (paragraph [P hereafter] 9-1 to 9-19).
2. Identify the income inclusions from deferred income plans (P 9-20 and 9-21).
3. Apply the rules related to education assistance payments, social assistance, workers' compensation payments and the universal child care benefit (P 9-22 to 9-27).
4. Determine the deductible amount of CPP contributions on self-employed income (P 9-28 to 9-31).
5. Determine the deductible amount of moving expenses for an individual (P 9-32 to 9-45).

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6. Determine the deductible amount of child care expenses (P 9-46 to 9-57).
7. Apply the provisions related to the disability supports deduction (P 9-58 to 9-66).
8. Apply the provisions related to EI benefits and repayments (P 9-67 and 9-68).
9. Explain the general rules for pension income splitting (P 9-69 to 9-77).
10. Explain the tax treatment of child support and spousal support payments and receipts (P 9-78 to 9-87).

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11. Determine the taxable portion of annuity payments received (P 9-88 to 9-96).
12. Describe the major features of Tax Free Savings Accounts (P 9-97 to 9-101).
13. Explain the provisions associated with Registered Education Savings Plans, Canada Education Savings Grants and Canada Learning Bonds (P 9-102 to 9-129).
14. Compare the major features of TFSAs, RRSPs and RESPs (P 9-130 to 9-138).
15. Describe the major features of Registered Disability Savings Plans (P 9-139 to 9-141).

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16. Determine the tax consequences of non-arm's length transfers of property at values other than fair market value (P 9-142 to 9-159).
17. Describe the special rollover provisions applicable to inter vivos transfers of capital property to a spouse (P 9-160 to 9-167).
18. Determine the tax consequences of non-arm's length transfers of depreciable property (P 9-168 to 9-172).
19. Describe the special rollover provisions applicable to inter vivos transfers of farm or fishing property to a child (P 9-173 to 9-176).
20. Explain the basic requirements for deemed dispositions on death and any rollovers available at that time (P 9-177 to 9-186).

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21. Apply the income attribution rules to inter vivos transfers of capital property to a spouse and to related individuals who are under the age of 18 (P 9-187 to 9-205).
22. Describe the income attribution rules applicable to transfers to other related parties (P 9-206 to 9-209).
23. Describe some of the anti-avoidance provisions that relate to the income attribution rules (P 9-210 and 9-211).
24. Describe some of the tax planning techniques that are available to mitigate the income attribution rules (P 9-212).

# CHAPTER 10

## How To Work Through Chapter 10

We recommend the following approach in dealing with the material in this Chapter:

### Planning For Retirement

- Read paragraph 10-1 to 10-19 (in the textbook).

### Registered Retirement Savings Plans (RRSPs)

- Read paragraph 10-20 to 10-36.
- Do Exercise Ten-1 (in the textbook) and check the solution in this Study Guide.
- Read paragraph 10-37.

### RRSP Deduction Limit

- Read paragraph 10-38 to 10-48.
- Do Exercises Ten-2 and Ten-3 and check the solutions in this Study Guide.

### Pension Adjustments (PAs)

- Read paragraph 10-49 to 10-51.
- Do Exercise Ten-4 and check the solution in this Study Guide.
- Read paragraph 10-52 to 10-59.
- Do Exercise Ten-5 and check the solution in this Study Guide.

### Past Service Pension Adjustments (PSPAs) And Pension Adjustment Reversals

- Read paragraph 10-60 to 10-71.
- Do Self Study Problem Ten-1 which is available on MyLab and check the solution in this Study Guide.

### Examples Of RRSP Deduction Calculations

- Read paragraph 10-72.
- Do Exercises Ten-6 and Ten-7 and check the solutions in this Study Guide.

### Undeducted And Excess RRSP Contributions, Including Tax Planning For

- Read paragraph 10-73 to 10-78.
- Do Exercise Ten-8 and check the solution in this Study Guide.
- Read paragraph 10-79 to 10-82.
- Do Self Study Problem Ten-2 to Ten-5 and check the solutions in this Study Guide.

### RRSP And RRIF Administration Fees

- Read paragraph 10-83.

### RRSP Withdrawals, Voluntary Conversions And Involuntary Termination (Age)

- Read paragraph 10-84 to 10-93.

**Spousal RRSP**

- Read paragraph 10-94 to 10-102.
- Do Exercise Ten-9 and check the solution in this Study Guide.

**Home Buyers' Plan (HBP) And Lifelong Learning Plan (LLP)**

- Read paragraph 10-103 to 10-113.
- Do Exercise Ten-10 and check the solution in this Study Guide.
- Read paragraph 10-114 to 10-122.
- Do Exercise Ten-11 and check the solution in this Study Guide.

**RRSPs - Departure From Canada And Death Of The RRSP Registrant**

- Read paragraph 10-123 to 10-138.
- Do Self Study Problem Ten-6 and check the solution in this Study Guide.

**Registered Pension Plans (RPPs)**

- Read paragraph 10-139 to 10-157.

**Pooled Registered Pension Plans, Target Benefit Plans And Expanded CPP**

- Read paragraph 10-158 to 10-167.

**Registered Retirement Income Funds (RRIFs) - General Rules**

- Read paragraph 10-168 to 10-178.
- Do Exercise Ten-12 and check the solution in this Study Guide.

**RRIFs - Death Of The RRIF Registrant And Evaluation Of RRIFs**

- Read paragraph 10-179 to 10-186.

**Deferred Profit Sharing Plans And Profit Sharing Plans**

- Read paragraph 10-187 to 10-196.

**Transfers Between Plans And Retiring Allowances**

- Read paragraph 10-197 to 10-200.
- Do Exercise Ten-13 and check the solution in this Study Guide.
- Do Self Study Problems Ten-7 and Ten-8 and check the solutions in this Study Guide.

**Retirement Compensation Arrangements, Salary Deferral Arrangements And Individual Pension Plans**

- Read paragraph 10-201 to 10-221.
- Do Self Study Problems Ten-9 and Ten-10 and check the solutions in this Study Guide.

**To Complete This Chapter**

- If you would like more practice in problem solving, do the Supplementary Self Study Problems for the chapter. These problems and solutions are available on MyLab.
- Review the Key Terms Used In This Chapter in the textbook at the end of Chapter 10. Consult the Glossary for the meaning of any key terms you do not know.
- Test yourself with the Chapter 10 Glossary Flashcards available on MyLab.
- Ensure you have achieved the Chapter 10 Learning Objectives listed in this Study Guide.
- As a review, we recommend you view the PowerPoint presentation for Chapter 10 that is on MyLab.

**Practice Examination**

- Write the Practice Examination for Chapter 10 that is on MyLab. Mark your examination using the Practice Examination Solution that is also on MyLab.

## Solutions to Chapter Ten Exercises

### *Exercise Ten - 1 Solution*

| Invested Inside RRSP | |
|---|---|
| Deductible Contribution | $20,000 |
| Dividends Received [(5)(5%)($20,000)] | 5,000 |
| Balance After Five Years | $25,000 |
| Tax On Withdrawal [(40%)($25,000)] | ( 10,000) |
| Available For Vacation | $15,000 |

| Invested Inside TFSA | |
|---|---|
| Initial Investment [($20,000)(1 - .40)] | $12,000 |
| Tax Free Dividends [(5)(5%)($12,000)] | 3,000 |
| Available For Vacation | $15,000 |

| Invested Outside RRSP And TFSA | |
|---|---|
| Initial Investment [($20,000)(1 - .40)] | $12,000 |
| After Tax Dividends [(5)(5%)($12,000)(1 - .22)] | 2,340 |
| Available For Vacation | $14,340 |

Investing outside the RRSP or TFSA is the worst alternative by $660 ($15,000 - $14,340).

### *Exercise Ten - 2 Solution*

His Earned Income for RRSP purposes would be $70,500 ($56,000 + $2,500 + $12,000).

### *Exercise Ten - 3 Solution*

Her Earned Income for RRSP purposes would be $54,500 ($82,000 + $3,000 - $12,500 - $18,000).

### *Exercise Ten - 4 Solution*

The basic mechanism here is the Pension Adjustment (PA). Individuals who belong to an RPP or a DPSP have their RRSP Deduction Limit reduced by the amount of their PA for the previous year. PAs are designed to reflect the amount of contributions or benefits that have been accumulated in employer sponsored RPPs and DPSPs.

### *Exercise Ten - 5 Solution*

The Pension Adjustment will be $6,400 ($2,300 + $1,800 + $2,300).

### *Exercise Ten - 6 Solution*

The required calculations would be as follows:

| | |
|---|---|
| Unused Deduction Room - End Of 2018 | $4,800 |
| Lesser Of: | |
| • 2019 RRSP Dollar Limit = $26,500 | |
| • 18% Of 2018 Earned Income Of $38,000 = $6,840 | 6,840 |
| 2019 RRSP Deduction Limit | $11,640 |
| RRSP Deduction Is Least Of: | |
| • RRSP Deduction Limit = $11,640 | |
| • Available Contributions = $6,000 | |
| • Amount Mr. Haslich Chooses To Deduct = $4,500 | ( 4,500) |
| Unused RRSP Deduction Room - End Of 2019 | $ 7,140 |

Assuming Mr. Haslich deducted only $4,500, he would have $1,500 ($6,000 - $4,500) in undeducted contributions that can be carried forward and deducted in a subsequent year.

If Mr. Haslich wanted to deduct his maximum RRSP deduction of $11,640, he would have to contribute an additional $5,640 ($11,640 - $6,000).

### *Exercise Ten - 7 Solution*

The required calculations would be as follows:

| | |
|---|---|
| Unused Deduction Room - End Of 2018 | $10,750 |
| Lesser Of: | |
| • 2019 RRSP Dollar Limit = $26,500 | |
| • 18% Of 2018 Earned Income Of $66,530* = $11,975 | 11,975 |
| Less 2018 PA | ( 4,800) |
| 2019 RRSP Deduction Limit | $17,925 |
| RRSP Deduction Is Lesser Of: | |
| • RRSP Deduction Limit = $17,925 | |
| • Available Contributions = $19,760 ($6,560 + $13,200) | ( 17,925) |
| Unused RRSP Deduction Room - End Of 2019 | Nil |

*Earned Income = $6,530 - $18,000 + $75,600 + $2,400 (RPP)

Mr. Black's maximum RRSP deduction is $17,925. While he has no Unused RRSP Deduction Room, he has $1,835 ($19,760 - $17,925) in undeducted contributions that can be carried forward and deducted in a subsequent year in which there is sufficient RRSP deduction room.

### *Exercise Ten - 8 Solution*

In 2017 and 2018, 18 percent of Ms. Brownell's $160,000 in earned income is more than the RRSP dollar limit for those years. Her 2019 earned income is not relevant in this Exercise as it will not be used until 2020. Given this, the calculation of the excess amount of contributions is as follows:

| | |
|---|---|
| 2018 Contribution (July 1) | $27,350 |
| 2018 Addition To Deduction Room = RRSP Dollar Limit | ( 26,230) |
| Excess Contributions For 2018 (Less Than $2,000) | $ 1,120 |
| 2019 Contribution (May 1) | 30,000 |
| 2019 Addition To Deduction Room = RRSP Dollar Limit | ( 26,500) |
| Permitted $2,000 Cushion | ( 2,000) |
| Excess Contributions Subject To Penalty | $ 2,620 |

As the excess contribution for 2018 was less than $2,000, there is no penalty for that year. There will be a 2019 penalty of $210 [(1%)($2,620)(8 Months)]. The fact that there is no RRSP deduction is not relevant to the penalty.

### *Exercise Ten - 9 Solution*

As a spousal contribution was made in 2018, one of the two years prior to 2019, income attribution will apply. However, it will only apply to the extent of the $5,000 contribution made by Mrs. Garveau. This means that $5,000 of the withdrawal will be taxed in the hands of Mrs. Garveau, with the remaining $4,000 taxed in the hands of Mr. Garveau.

### *Exercise Ten - 10 Solution*

Ms. DeBoo will have to repay $867 [(1/15)($18,000 - $5,000)] during 2019. Note that the voluntary payment that was made during 2018 did not reduce the fraction of the remaining balance that must be paid in 2019.

### *Exercise Ten - 11 Solution*

There are no tax consequences associated with the withdrawal of $5,000. He is not enrolled in a qualifying education program in either 2018 or 2019 and, as a consequence, his repayment period begins in 2019. As he makes the required payments of $500 ($5,000 ÷ 10) within 60 days of the end of each of the years 2019 through 2028, there are no tax consequences associated with his repayments.

### *Exercise Ten - 12 Solution*

He has no required minimum withdrawal for 2019, the year the RRIF is established. His minimum withdrawal for 2020 will be $27,500 [$660,000 ÷ (90 - 66)].

### *Exercise Ten - 13 Solution*

It would appear that Mr. Bartoli began working for his employer in 1976. Given this, he can rollover a total of $59,500 [($2,000)(20 Years Before 1996) + ($1,500)(13 Years Before 1989)] to his RRSP. The remainder of the retiring allowance will be taxed in 2019.

## Self Study Solution Ten - 1

### *Case 1*

The required 2019 PA would be calculated as follows:

| | |
|---|---|
| Employer's Contribution To DPSP | $2,500 |
| Employer's Contribution To RPP | 1,000 |
| Fredia's Contribution To RPP | 1,000 |
| PA | $4,500 |

### *Case 2*

The required 2019 PA would be calculated as follows:

[(1.25%)(9)($71,000)] = $7,988

Note that the contributions made during 2019 have no influence on the PA for a defined benefit RPP.

### *Case 3*

The required PSPA would be calculated as follows:

| | |
|---|---|
| 2017 Amount [(1.1%)(9)($38,000)] | $3,762 |
| 2018 Amount [(1.1%)(9)($42,000)] | 4,158 |
| 2019 PSPA | $7,920 |

In addition to the PSPA calculated above, there would be a 2019 PA of $5,049 [(1.1%)(9)($51,000)].

### *Case 4*

The required PAR would be calculated as follows:

| | |
|---|---|
| 2017 PA | $ 5,200 |
| 2018 PA | 5,400 |
| 2019 PAR | $10,600 |

***Case 5***

The required PSPA would be calculated as follows:

| | |
|---|---|
| 2017 Amount [(1.5% - 1.3%)(9)($58,000)] | $1,044 |
| 2018 Amount [(1.5% - 1.3%)(9)($62,000)] | 1,116 |
| 2019 PSPA | $2,160 |

There would also be a 2019 PA. However, this cannot be calculated as the problem does not provide the 2019 pensionable earnings.

## Self Study Solution Ten - 2

***Part A - Maximum RRSP Deduction***

Deeta's maximum 2019 RRSP deduction would be calculated as follows:

| | |
|---|---|
| Unused Deduction Room - January 1, 2018 | $35,000 |
| 2018 Addition | Nil |
| 2019 Addition (Based On 2018 Earned Income Of Nil) | Nil |
| Maximum 2019 RRSP Deduction | $35,000 |

***Part B - Excess RRSP Contributions***

At the beginning of 2018, Deeta's undeducted contributions of $37,000 are equal to her $35,000 unused deduction room, plus the permitted $2,000 cushion. As she withdraws $25,000 and made no further contributions during 2018, there are no excess contributions during the 2018 taxation year.

The excess contributions for 2019 would be calculated as follows:

| | |
|---|---|
| Undeducted Contributions | |
| January 1, 2019 ($37,000 - $25,000) | $12,000 |
| Additional Contribution On May 2, 2019 | 40,000 |
| Total Undeducted Contributions | $52,000 |
| Unused Deduction Room | ( 35,000) |
| Permitted Cushion | ( 2,000) |
| Excess Contributions Subject To Penalty | $15,000 |
| Penalty Rate | 1% |
| Monthly Penalty | $ 150 |
| Months (May To December) | 8 |
| Total Penalty For 2019 | $ 1,200 |

***Part C - Advice On Tax Planning***

As the preceding calculation demonstrates, Deeta's excess contributions are attracting a significant penalty, based on a monthly charge of 1 percent of the excess amount.

As her earned income for 2019 will be $61,000, the addition to her 2020 deduction room will be $10,980. As her December 31, 2019 excess contributions are $15,000, she will need to withdraw $4,020 ($15,000 - $10,980) in order to avoid having an additional penalty in 2020. If the excess contributions are withdrawn from the RRSP prior to the end of the year following the year in which an assessment is received for the year in which the contribution is made, an offsetting deduction is available. If, however, any excess is not withdrawn within this specified time frame, it will be included in income and taxed on withdrawal, even though it was never deducted from income. Deeta should withdraw the $4,020 immediately to stop the assessment of the penalty.

Since she has never had a TFSA, she should open one. The withdrawn funds should be contributed to her TFSA, along with any other excess funds up to her TFSA contribution room. For 2019, the maximum total contributions are $63,500 and, while TFSA contributions are not deductible, earnings accumulate on a tax free basis. In addition, withdrawals can be made without tax consequences.

Whether Deeta should withdraw the $2,000 cushion as well depends on future expectations. As there is no time limit on using contributions that are in the plan, it would make sense to simply leave the $2,000 in place, provided that she expects to have earned income in some future year.

In the future, she should ensure that she continues to contribute to her RRSP and TFSA, but should limit the amounts to the maximum permitted contribution.

## Self Study Solution Ten - 3

Mr. Barnes' 2018 Earned Income for RRSP purposes would be calculated as follows:

| | |
|---|---|
| Salary | $55,000 |
| Taxable Benefits | 1,150 |
| Union Dues | ( 175) |
| Net Employment Income | $55,975 |
| Business Income | 4,150 |
| Rental Loss | ( 11,875) |
| Spousal Support Received | 2,400 |
| Earned Income | $50,650 |

Note that CPP and EI contributions do not reduce Earned Income for RRSP purposes.

Since Mr. Barnes has no undeducted RRSP contributions, his maximum deductible RRSP contribution for 2019 is equal to his RRSP Deduction Limit.

This is calculated for Part A (not a member of RPP or DPSP) and Part B (member of RPP) as follows:

| | Part A | Part B |
|---|---|---|
| Unused Deduction Room - End Of 2018 | Nil | Nil |
| Annual Addition - Lesser Of: | | |
| • 2019 RRSP Dollar Limit = $26,500 | | |
| • 18% of 2018 Earned Income Of $50,650 = $9,117 | 9,117 | 9,117 |
| Less 2018 PA | N/A | ( 4,200) |
| Maximum Deductible RRSP Contribution | $9,117 | $4,917 |

## Self Study Solution Ten - 4

The annual addition for 2019 would be the lesser of $26,500 and 18 percent of Earned Income for 2018. The latter amount would be calculated as follows:

| | |
|---|---|
| Salary | $86,200 |
| Taxable Benefits | 5,600 |
| RPP Contributions (Note 1) | Nil |
| Union Dues | ( 450) |
| Net Employment Income (RRSP Figure) | $91,350 |
| Business Loss | ( 4,500) |
| Rental Income | 6,700 |
| Common-Law Partner Support Paid | ( 12,000) |
| Eligible Dividends (Note 2) | Nil |
| Interest (Note 2) | Nil |
| 2018 Earned Income | $81,550 |
| Rate | 18% |
| Annual Addition (Less Than $26,500) | $14,679 |

**Note 1** While Ms. Storm's RPP contribution would be deducted in determining Net Income For Tax Purposes, it is not deducted in calculating employment income for RRSP Earned Income purposes.

**Note 2** Neither the eligible dividends nor the interest are part of RRSP Earned Income.

Ms. Storm's maximum deductible RRSP contribution would be calculated as follows:

| | |
|---|---|
| Opening Unused RRSP Deduction Room | $17,000 |
| Annual Addition | 14,679 |
| 2018 Pension Adjustment [(2)($2,500)] | ( 5,000) |
| RRSP Deduction Limit For 2019 | $26,679 |
| Undeducted Contributions From Prior Years | ( 8,000) |
| Maximum Deductible Contribution For 2019 | $18,679 |

## Self Study Solution Ten - 5

### *Part A*

For purposes of determining her maximum 2019 RRSP contribution, 2018 Earned Income would be calculated as follows:

| | | |
|---|---|---|
| Net Employment Income* | | |
| Salary | $150,000 | |
| Automobile Benefit | 6,500 | |
| Employee Stock Option Benefit | 3,000 | |
| Benefit On Interest Free Loan | 1,500 | |
| Deductible Employment Expenses | ( 3,400) | $157,600 |
| Net Business Income | | 14,600 |
| Royalty Income (Own Invention) | | 6,600 |
| Net Rental Loss | | ( 10,000) |
| Spousal Support Received | | 24,000 |
| Earned Income | | $192,800 |

*Note that, in calculating Earned Income for RRSP purposes, no deduction is made from net employment income for contributions made to an RPP.

A listing of the items that are not included in the calculation of Earned Income is as follows:

- Registered Pension Plan Contributions
- Interest Income
- Taxable Capital Gains
- Eligible Dividends

### Part B

The calculation of Sherly's maximum deductible RRSP contribution for 2019 is as follows:

| | |
|---|---|
| 2017 RRSP Dollar Limit | $26,010 |
| 2018 RRSP Dollar Limit | 26,230 |
| Opening Unused RRSP Deduction Room | $52,240 |
| Annual Addition - Lesser Of: | |
| • 2019 RRSP Dollar Limit = $26,500 | |
| • 18 Percent Of 2018 Earned Income | |
| [(18%)($192,800)] = $34,704 | 26,500 |
| 2018 PA | ( 15,000) |
| Maximum Deductible RRSP Contribution For 2019 | $63,740 |

## Self Study Solution Ten - 6

### Part A

Mr. Sabatini's minimum net employment income would be calculated as follows:

| | |
|---|---|
| Salary | $ 58,000 |
| Commissions | 74,000 |
| Registered Pension Plan Contributions | ( 3,500) |
| Net Disability Benefits (Note 1) | 3,950 |
| Life Insurance Premium Taxable Benefit | |
| [(50%)($3,000)] | 1,500 |
| Automobile Benefit (Note 2) | 6,671 |
| Stock Option Benefit | |
| [($23.50 - $12.50)(1,000 Shares)] | 11,000 |
| Golf And Country Club Costs (Note 3) | ( 3,400) |
| Net Employment Income | $148,221 |

**Note 1** As Mr. Sabatini's employer has made contributions to the sickness and accident plan, the benefit of $4,500 is taxable. This is reduced by the payments of $550 [($100)(12 - 1)/2] that were made by Mr. Sabatini during the year, leaving a net benefit of $3,950.

**Note 2** With respect to the standby charge, Mr. Sabatini's employment related usage is over 50 percent of the total and, as a consequence, he can reduce his standby charge to the extent of personal usage that is less than 1,667 kilometers per month. Also note that, as the car was not available during November, his standby charge would be based on 335 days of availability. This would be rounded to 11 months (335/30). Given this, the standby charge would be as follows:

[($68,000)(11 Months)(2%)(7,000/18,337)] = $5,711

As Mr. Sabatini's employment related use was over 50 percent of the total use, he can base his operating cost benefit on one-half of the standby charge. Given this, the benefit would be the lesser of:

- [($0.28)(7,000)] = $1,960; and
- [(1/2)($5,711)] = $2,856

Using the lesser figure of $1,960, the total benefit would be calculated as follows:

| | |
|---|---|
| Standby Charge | $5,711 |
| Operating Cost Benefit | 1,960 |
| Payment To Employer | ( 1,000) |
| Total Automobile Benefit | $6,671 |

**Note 3** Only 50 percent of the $6,800 country club entertainment costs can be deducted by Mr. Sabatini. The $5,000 membership fee would not be a taxable benefit and would not be deductible by his employer.

**Other Notes**

- The travel costs that the corporation reimbursed to Mr. Sabatini have no tax effect.
- The CPP and EI contributions are not deductible. They can be used to create credits against Tax Payable.
- Income taxes withheld are not deductible.
- Donations to a registered charity will create a credit against Tax Payable, but cannot be deducted in the determination of net employment income.
- Parking fees related to Mr. Sabatini's normal employment location are not deductible.
- Although he cannot deduct his share of the life insurance premiums, the life insurance proceeds will not be taxable.
- The use of frequent flyer points earned on employment related travel does not normally create a taxable benefit.
- The discounts on merchandise provided by the employer are not a taxable benefit.

### Part B

Mr. Sabatini's 2018 Earned Income and maximum deductible 2019 RRSP contribution would be calculated as follows:

| | |
|---|---|
| 2018 Earned Income From Employment (Given) | $116,000 |
| 2018 Business Loss | ( 12,500) |
| 2018 Rental Income | 7,500 |
| 2018 Earned Income | $111,000 |
| | |
| Unused Deduction Room - End Of 2018 | Nil |
| Annual Addition - Lesser Of: | |
| • 2019 RRSP Dollar Limit = $26,500 | |
| • 18% of 2018 Earned Income Of $111,000 = $19,980 | $19,980 |
| Less 2018 PA | ( 6,800) |
| 2019 RRSP Deduction Limit | $13,180 |
| | |
| RRSP Deduction For 2019 | $ 2,600 |

While Mr. Sabatini has deduction room of $13,180, only the $2,600 contribution to his wife's plan can be deducted. His $10,000 contribution to his own RRSP is not relevant as it was deducted in the previous year.

### Part C

Since the RRSP has no beneficiary specified, an amount equal to the fair market value of all the property held in the RRSP at the time of death will have to be reported on Mr. Sabatini's return for 2020, the year of death.

### Part D

Since Mr. Sabatini's wife is the sole beneficiary, she can choose to transfer all the assets in the RRSP to an RRSP in her name. If this is done, there will be no tax consequences for either his wife or Mr. Sabatini's final return. This would likely be the most tax advantageous arrangement for dealing with Mr. Sabatini's RRSP.

Note that there are also provisions that allow RRSPs to be transferred to a financially dependent child on a basis that shifts the tax burden to the child. Given Mr. Sabatini is receiving child support for an 8 year son, this approach might also be tax advantageous.

## Self Study Solution Ten - 7

### General Tax Planning Goals

The most desirable solution would be to find benefits that would be fully deductible to the Company and free of taxation for Mr. Jones. The only items that fall into this category would be:

- payments for private health care plans;
- payments for disability insurance;
- discounts on company merchandise; and
- annual non-cash gifts with a value of $500 or less.

Discounts on industrial engines are not likely to be of any value to Mr. Jones. However, Mr. Jones should arrange to have the Company provide private health care coverage, including a dental plan. The Company could also pay the premiums on a disability insurance plan without it becoming a taxable benefit to Mr. Jones at the time of payment (benefits received would be taxable). Finally, an annual non-cash gift with a value of $500 or less would be deductible to the company and received tax free by Mr. Jones.

### Use Of RPP, DPSP, RRSP And Retiring Allowance

In terms of tax deferral, Mr. Jones should be included in the Company's Registered Pension Plan (RPP). Once he is admitted to the plan, both he and the Company should make the maximum contributions that are permitted under the terms of the plan. The limiting factor here is that these contributions cannot result in a Pension Adjustment that is in excess of the lesser of 18 percent of Mr. Jones' compensation for the year or the money purchase limit for the year under consideration ($27,230 for 2019).

While there is no indication that the Company has such an arrangement, a Deferred Profit Sharing Plan (DPSP) might also be useful. Whether or not Mr. Jones would be able to use such an arrangement would depend on the total employee/employer contributions to the Company's RPP. Contributions to a DPSP are included in the calculation of Mr. Jones' Pension Adjustment and, when combined with the RPP contributions, the total is subject to the limitation described in the preceding paragraph.

### Housing Loan

The Company could provide a loan to Mr. Jones to purchase his new residence. A low interest or interest free loan will result in imputed interest being added to Mr. Jones' Taxable Income without an offsetting deduction. Note, however, that the prescribed rate for this purpose is at the low rate of 2 percent. At this rate, even if the loan is interest free, the taxable benefit associated with such loans is fairly small and could make a large interest free loan desirable. On the $100,000 he requires to buy a residence, the benefit on an interest free loan would only be $2,000 [(2%)(100,000)].

As there is an intent to compensate, arrangements would have to be made for forgiving the loan after Mr. Jones retires. While such forgiveness would be taxable to Mr. Jones, he expects to be in a lower tax bracket after retiring, resulting in an absolute tax savings.

### *Company Car*

The Company could provide Mr. Jones with an automobile. In this case, Mr. Jones will be assessed for a personal benefit of a standby charge (24 percent per year of the capital cost or two-thirds of the lease payments, if he is not eligible for a reduction) and for operating costs (one-half of the standby charge or $0.28 per kilometer of personal use). Whether or not this will be desirable depends on an analysis of how Mr. Jones would actually use the car. In some cases, especially if the car has a list price of more than $30,000, the taxable benefit may exceed the actual benefit, making this an undesirable form of compensation.

### *Recreational Facilities*

The Company could pay the dues for any recreational facilities that Mr. Jones might wish to use. While these amounts will not be treated as a taxable benefit to Mr. Jones, the payments will not be deductible to the Company. Given that the Company is subject to a marginal tax rate that is lower than Mr. Jones' combined rate, it is unlikely the Company would agree to do this.

### *Moving Costs*

The Company could provide assistance with the costs that will be incurred by Mr. Jones in moving to Hamilton. With respect to costs that Mr. Jones would be permitted to deduct, it makes little difference whether the Company pays the costs, or simply pays an equivalent amount in salary and lets Mr. Jones pay the costs and deduct them. However, certain types of moving costs that would not be deductible by Mr. Jones can be paid by the Company without creating a taxable benefit. An example of this would be compensation for a loss on a personal residence owned by Mr. Jones if a loss exists on his house in Windsor. (See Chapter 9)

### *Bonus And/Or Stock Options*

If Martin Manufacturing has a year end after July 6, it can declare a bonus in the third year, but not pay it until the following calendar year. This will defer Mr. Jones' taxation of the bonus by one year without deferring Martin's deduction.

As an incentive, the Company could grant Mr. Jones options to purchase its stock. This would have no tax cost to the Company. The timing of the tax cost of the options for Mr. Jones could be delayed until after retirement.

### *Services As A Self-Employed Contractor Or Through A Corporation*

Since Mr. Jones has been operating as a consultant, it may be possible to structure the project so that he will be considered an independent contractor rather than an employee. This would considerably increase the amount and type of expenditures that would be deductible by him and also create an opportunity to income split with his wife, if she could assist him in the project in some way. Her assistance would have to have a business purpose (supernatural phenomena expertise would have questionable value) and any payments to her would have to be reasonable in the circumstances.

In considering this alternative it should be kept in mind that, if Mr. Jones is not an employee, some of the possibilities that have been previously discussed would no longer be feasible. For example, unless Mr. Jones is an employee, it would not be possible for him to be a member of the Company's RPP.

Another possibility would be for Mr. Jones to provide his services through a corporation. However, this would probably not be helpful. Given his relationship with Martin Manufacturing Company, any corporation would likely be viewed as a personal services business and taxed at full corporate rates. (Personal services corporations are covered in Chapter 12, Taxable Income And Tax Payable For Corporations.)

# Self Study Solution Ten - 8

## Part A - RRSP Contribution

In order to calculate the maximum deductible RRSP contribution, net employment income and net rental income must first be calculated.

### *Net Employment Income*

The calculations required for 2018 (to be used in the RRSP earned income calculation) and 2019 would be as follows:

| | 2018 | 2019 |
|---|---|---|
| Gross Salary | $47,000 | $53,000 |
| Commissions | 6,200 | 7,800 |
| RPP Contributions | ( 1,800) | ( 1,950) |
| Work Space In Home Costs (Note 1) | ( 1,001) | ( 1,073) |
| Net Employment Income | $50,399 | $57,777 |

**Note 1** As an employee, Kerri cannot deduct either the listed mortgage interest or CCA on this office space. Because she has commission income, Kerri can deduct all of the other listed costs. Given this, the 2018 and 2019 deductions are as follows:

| | 2018 | 2019 |
|---|---|---|
| Utilities And Maintenance | $1,850 | $2,040 |
| Insurance | 625 | 715 |
| Property Taxes | 4,200 | 4,400 |
| Total | $6,675 | $7,155 |
| Percentage Used | 15% | 15% |
| Deductible Amount | $1,001 | $1,073 |

### *Net Rental Income*

The calculations required for 2018 and 2019 would be as follows:

| | 2018 | 2019 |
|---|---|---|
| Rents | $ 8,400 | $13,800 |
| Expenses Other Than CCA | ( 10,300) | ( 11,100) |
| Income (Loss) Before CCA | ($ 1,900) | $ 2,700 |
| CCA (Note 2) | N/A | ( 2,700) |
| Net Rental Income | ($ 1,900) | Nil |

**Note 2** As CCA cannot be used to increase or create a rental loss, no deduction can be made in 2018. For 2019, the maximum available CCA deduction is $10,400 [(4%)($340,000 - $80,000)]. However, the actual deduction is limited to the $2,700 of rental income prior to the deduction of CCA. The first year one-half rule is not applicable as this is the second year the property is owned. The fact that no CCA was deducted in the first year is not relevant.

### RRSP Calculations

Determining the appropriate amount here requires the calculation of Earned Income for 2018. The calculation is as follows:

| | |
|---|---|
| 2018 Net Employment Income | $50,399 |
| 2018 RPP Contributions Deducted | 1,800 |
| Spousal Support Received [(12)($500)] | 6,000 |
| 2018 Net Rental Loss | ( 1,900) |
| 2018 Earned Income | $56,299 |

Using this figure, Ms. Sosteric's maximum 2019 deduction, along with the additional contribution required to make this deduction, would be calculated as follows:

| | |
|---|---|
| Opening Unused Deduction Room | $ 6,200 |
| Annual Addition - Lesser Of: | |
| • 2019 RRSP Dollar Limit = $26,500 | |
| • 18% Of 2018 Earned Income Of $56,299 = $10,134 | 10,134 |
| Less 2018 PA (Employee And Employer RPP Contributions) | ( 3,600) |
| Maximum RRSP Deduction | $12,734 |
| Undeducted Contributions In Plan | ( 5,800) |
| Required Additional Contribution | $ 6,934 |

## Part B - Net Income For Tax Purposes And Taxable Income

### Other Required Information

While we can use several of the figures from Part A to calculate Net Income For Tax Purposes, two other items must be calculated before we can complete this figure.

### Taxable Capital Gain And Dividends - Employer's Shares

The tax consequences related to buying, holding, and selling her employer's shares are as follows:

| | |
|---|---|
| Proceeds Of Disposition [(5,000)($14.75)] | $73,750 |
| Adjusted Cost Base [(5,000)($12.00)] | ( 60,000) |
| Capital Gain | $13,750 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain | $ 6,875 |

| | |
|---|---|
| Eligible Dividends [(5,000)($0.60)] | $3,000 |

### Child Care Costs

Kerri's deductible child care costs are the least of three amounts:

**Actual Costs** The actual costs were given as $8,600.

**Annual Limit** The annual limit is $13,000 ($8,000 for Barry and $5,000 for Kim).

**Income Limit** For this purpose, Ms. Sosteric's "earned income" is her gross employment income of $60,800 ($53,000 + $7,800). Two-thirds of this amount is $40,533.

The least of these figures is the actual costs of $8,600.

As Ms. Sosteric has no deductions applicable to the determination of Taxable Income, her Taxable Income is equal to her Net Income For Tax Purposes which is as follow:

| | |
|---|---|
| Net Employment Income (Part A) | $57,777 |
| Net Rental Income (Part A) | Nil |
| RRSP Deduction (Part A) | ( 12,734) |
| Spousal Support Received | 6,000 |
| Taxable Capital Gains | 6,875 |
| Eligible Dividends [(5,000)($0.60)] | 3,000 |
| Gross Up [(38%)($3,000)] | 1,140 |
| Child Care Costs | ( 8,600) |
| Net Income For Tax Purposes And Taxable Income | $53,458 |

## Part B - Tax Payable

The required calculations for her Tax Payable are as follows:

| | | |
|---|---|---|
| Tax On First $47,630 | | $7,145 |
| Tax On Next $5,828 ($53,458 - $47,630) At 20.5 Percent | | 1,195 |
| Tax Before Credits | | $8,340 |
| Tax Credits: | | |
| Basic Personal Amount | ($12,069) | |
| Eligible Dependant - Either Child | ( 12,069) | |
| EI Premiums | ( 860) | |
| CPP Contributions | ( 2,749) | |
| Canada Employment | ( 1,222) | |
| Medical Expenses (Note 3) | ( 1,016) | |
| Total Credit Base | ($29,985) | |
| Rate | 15% | ( 4,498) |
| Dividend Tax Credit [(6/11)($1,140)] | | ( 622) |
| Federal Tax Payable | | $3,220 |

**Note 3** The base for Ms. Sosteric's medical expense tax credit would be calculated as follows:

| | |
|---|---|
| Eligible Expenses | $2,620 |
| Reduced By The Lesser Of: | |
| • [(3%)($53,458)] = $1,604 | |
| • 2019 Threshold Amount = $2,352 | ( 1,604) |
| Base For Credit | $1,016 |

# Self Study Solution Ten - 9

## Part A - Spousal RRSP Contribution

As noted in the problem, we are to assume that Ahmed's 2018 Earned Income is equal to his 2019 Earned Income. In order to calculate the 2019 Earned Income, we need to calculate both net employment income and net rental income. These are the only components of Mr. Sidi's Earned Income.

### *Net Employment Income*

Even though Ahmed is no longer an employee, he has employment income related to the exercise of his stock option shares. The calculations are as follows:

| | |
|---|---|
| Exercise Date Value [(5,000)($21)] | $105,000 |
| Option Price [(5,000)($15)] | ( 75,000) |
| Employment Income Inclusion | $ 30,000 |

There will be a deduction in the determination of Taxable Income equal to one-half of this inclusion or $15,000.

### *Net Rental Income*

The required calculations here are as follows:

| | |
|---|---|
| Revenues ($34,000 + $42,000 + $26,000) | $102,000 |
| Recapture On Property A (Note 1) | 138,000 |
| Expenses Other Than CCA ($29,000 + $37,000 + $23,000) | ( 89,000) |
| CCA (Note 1) | ( 38,240) |
| Net Rental Income | $112,760 |

**Note 1** CCA on the rental properties would be calculated as follows:

| | Property A | Property B | Property C |
|---|---|---|---|
| UCC On January 1 | $422,000 | $571,000 | $385,000 |
| Dispositions - Capital Cost | ( 560,000) | N/A | N/A |
| Subtotal | ($138,000) | $571,000 | $385,000 |
| Recapture | 138,000 | N/A | N/A |
| Balance Subject To CCA | Nil | $571,000 | $385,000 |
| Rate | N/A | 4% | 4% |
| CCA | Nil | $ 22,840 | $ 15,400 |

The total 2019 CCA would be $38,240 ($22,840 + $15,400).

### *RRSP Deduction*

Since we are assuming that Ahmed's 2018 Earned Income is equal to his 2019 Earned Income, the required figure is calculated as follows:

| | |
|---|---|
| Employment Income | $ 30,000 |
| Net Rental Income | 112,760 |
| 2018 Earned Income (Assumed To Be Equal To 2019) | $142,760 |

The maximum deductible spousal RRSP contribution for 2019 would be the lesser of $25,697 [(18%)($142,760)] and the 2019 RRSP Dollar Limit of $26,500. Using the lesser figure, the maximum deductible contribution would be $25,697.

## Part B - Net Income For Tax Purposes

While the employment income and rental income figures from Part A are components of Net Income For Tax Purposes, other figures are needed to complete this Part B calculation.

### *Taxable Capital Gains*

There will be a taxable capital gain on the sale of the shares, calculated as follows:

| | |
|---|---|
| Proceeds Of Disposition [(5,000)($23)] | $115,000 |
| Adjusted Cost Base [(5,000)($21)] | ( 105,000) |
| Capital Gain | $ 10,000 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain | $ 5,000 |

In addition, there will be a capital gain on the sale of Property A, calculated as follows:

| | Land | Building |
|---|---|---|
| Proceeds Of Disposition | $340,000 | $620,000 |
| Adjusted Cost Base/Capital Cost | ( 100,000) | ( 560,000) |
| Capital Gain | $240,000 | $ 60,000 |

The total capital gain is $300,000 ($240,000 + $60,000). However, as the total proceeds were not collected in the year of sale, he can reduce his income inclusion through the use of a reserve.

| | |
|---|---|
| Total Capital Gain ($240,000 + $60,000) | $300,000 |
| Reserve - Lesser Of: | |
| • [($300,000)($864,000 ÷ $960,000)] = $270,000 | |
| • [($300,000)(20%)(4 - 0)] = $240,000 | ( 240,000) |
| Capital Gain | $ 60,000 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain For 2019 | $ 30,000 |

### *Minimum RRIF Withdrawal*

A registrant can irrevocably elect to base the minimum RRIF withdrawal calculation on the age of his spouse rather than his own age. If the spouse is younger, this will minimize the required withdrawal. Adrianna is aged 66, which is 5 years younger than Ahmed.

For individuals under the age of 71, the minimum RRIF withdrawal is calculated by dividing the fair market value of the assets in the plan at the beginning of the year by the number 90, less the registrant's age, or the spouse's age if elected.

The minimum RRIF withdrawal would be $52,083 [$1,250,000 ÷ (90 - 66)].

### *Pension Income Splitting*

The election to split CPP benefits is provided for in the Canada Pension Plan regulations and results in an actual split of the payments. The ITA 60.03 legislation allows certain other types of pension income to be split. Both payments of RPPs and withdrawals from RRIFs qualify for this split which is implemented solely on the tax returns. The total qualifying pension income for Ahmed is $138,083 ($86,000 + $52,083), one-half of which is $69,042.

***Net Income For Tax Purposes***

Based on the preceding calculations and the Other Information provided in the problem, Ahmed's minimum Net Income For Tax Purposes can be calculated as follows:

| | |
|---|---|
| Employment Income - Part A | $ 30,000 |
| Net Rental Income - Part A | 112,760 |
| Spousal RRSP Deduction - Part A | ( 25,697) |
| RPP Receipts (Pension Split) | 86,000 |
| CPP Receipts After Election To Split With Wife | 5,500 |
| Taxable Capital Gain - Option Shares | 5,000 |
| Taxable Capital Gain - Rental Property | 30,000 |
| Minimum RRIF Withdrawal (Pension Split) | 52,083 |
| Interest From Canadian Sources | 18,000 |
| Eligible Dividends Received | 2,200 |
| Gross Up [(38%)($2,200)] | 836 |
| Foreign Source Interest (100 Percent) | 3,000 |
| Net Income For Tax Purposes Before Pension Split | $319,682 |
| Income Allocated To Wife [(1/2)($86,000 + $52,083)] | ( 69,042) |
| Net Income For Tax Purposes | $250,640 |

## Part B - Taxable Income

Ahmed's Taxable Income would be calculated as follows:

| | |
|---|---|
| Net Income For Tax Purposes | $250,640 |
| Stock Option Deduction - Part A | ( 15,000) |
| Taxable Income | $235,640 |

## Part B - Tax Payable

As the problem requires the minimum Tax Payable, Ahmed has claimed the credits for his son, the medical expenses and charitable donations. These could have been claimed by Adrianna. The required calculations are as follows:

| | | |
|---|---|---|
| Tax On First $210,371 | | $48,719 |
| Tax On Next $25,269 ($235,640 - $210,371) At 33 Percent | | 8,339 |
| Tax Before Credits | | $57,058 |
| Tax Credits: | | |
| Basic Personal Amount | ($12,069) | |
| Spousal (Note 2) | Nil | |
| Age (Net Income Too High) | Nil | |
| Canada Caregiver - Son | ( 7,140) | |
| Canada Employment | ( 1,222) | |
| Pension Income | ( 2,000) | |
| Transfer Of Disability From Son | ( 8,416) | |
| Medical Expenses (Note 3) | ( 13,048) | |
| Total Credit Base | ($43,895) | |
| Rate | 15% | ( 6,584) |
| Charitable Donations (Note 4) | | ( 1,284) |
| Dividend Tax Credit On Eligible Dividends [(6/11)($836)] | | ( 456) |
| Foreign Tax Credit (Amount Withheld) | | ( 300) |
| Federal Tax Payable | | $48,434 |

**Note 2** While Adrianna has only $7,500 of OAS and the $5,500 in CPP benefits in her name, the added amounts resulting from the pension income splitting of more than $69,000 will be more than enough to eliminate the spousal tax credit. This additional income will use up all of her other tax credits (age and pension), preventing any transfers to Ahmed.

**Note 3** The base for the medical expense tax credit is calculated as follows:

| | | |
|---|---|---|
| Ahmed And Adrianna ($2,500 + $3,100) | | $5,600 |
| Lesser Of: | | |
| • [(3%)($250,640)] = $7,519 | | |
| • 2019 Threshold Amount = $2,352 | | ( 2,352) |
| Subtotal | | $ 3,248 |
| Son's Medical Expenses | $9,800 | |
| Reduced By The Lesser Of: | | |
| • $2,352 | | |
| • [(3%)(Nil)] = Nil | Nil | 9,800 |
| Allowable Amount Of Medical Expenses | | $13,048 |

**Note 4** Ahmed's charitable donations tax credit would be calculated as follows:

| | |
|---|---|
| 15 Percent Of $200 | $ 30 |
| 33 Percent Of The Lesser Of: | |
| ($4,000 - $200) = $3,800 | |
| ($235,640 - $210,371) = $25,269 | 1,254 |
| Total Credit | $1,284 |

## Part C - Pension Income Splitting

Given Ahmed's high Taxable Income, even after pension splitting, more than $25,000 is being taxed at the maximum 33 percent federal rate. Despite splitting the maximum amount of pension income, none of Adrianna's income is taxed at higher than 20.5 percent federally.

As a result, maximum pension income splitting appears to be advantageous if only federal tax rates are considered.

What should also be considered is the effect of the pension income splitting on the OAS clawback for Adrianna and the effect of provincial income taxes on both Ahmed and Adrianna. The effect of the OAS clawback and provincial taxes could make it more advantageous to reduce the amount of income splitting so that Adrianna's Net Income For Tax Purposes is below the OAS clawback income threshold.

While the ability to claim more medical expenses could be a factor in some pension income splitting analyses, it would have very little influence in this case given the high levels of Net Income involved.

## Chapter 10 Learning Objectives

After completing Chapter 10, you should be able to:

1. Explain the general procedures used to provide tax deferral on retirement saving (paragraph [P hereafter] 10-1 to 10-16).
2. Describe the difference between a defined benefit pension plan and a defined contribution (a.k.a. money purchase) pension plan (P 10-17 to 10-19).
3. Describe the basic operation of RRSPs (P 10-20 to 10-37).
4. Understand the terms: RRSP Deduction Limit, Unused RRSP Deduction Room and RRSP Dollar Limit (P 10-38 to 10-45).
5. Calculate Earned Income for RRSP purposes (P 10-46 to 10-48).

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6. Explain the concepts underlying Pension Adjustments (PAs) (P 10-49 to 10-60).
7. Explain the concepts underlying Past Service Pension Adjustments (PSPAs) (P 10-61 to 10-66).
8. Explain the concepts underlying Pension Adjustment Reversals (PARs) (P 10-67 to 10-71).
9. Calculate an individual's maximum RRSP deduction and Unused RRSP Deduction Room (P 10-72).
10. Apply the tax treatment for undeducted RRSP contributions (P 10-73 and 10-74).

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11. Determine whether an individual has made "excess" contributions to an RRSP and identify associated tax planning issues including the use of TFSAs (P 10-75 to 10-82).
12. Recall the tax treatment of RRSP and RRIF administration fees (P 10-83).
13. Apply the provisions relating to RRSP withdrawals and voluntary conversions of RRSPs (P 10-84 to 10-91).
14. Apply the provisions relating to RRSP terminations due to the age limitation (P 10-92 to 10-93).
15. Apply the provisions associated with spousal RRSPs and identify associated tax planning issues (P 10-94 to 10-102).

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16. Describe and apply the provisions of the Home Buyers' Plan (P 10-103 to 10-113).
17. Describe and apply the provisions of the Lifelong Learning Plan (P 10-114 to 10-122).
18. Apply the RRSP provisions relating to departure from Canada and death of the registrant (P 10-123 to 10-138).
19. Explain the general provisions associated with Registered Pension Plans (RPPs) (P 10-139 to 10-157).
20. Describe, in general terms, Pooled Registered Pension Plans (PRPPs) and Target Benefit Plans (P 10-158 to 10-161).

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21. Describe how an expanded CPP program could help the retirement savings problem (P 10-162 to 10-167).
22. Describe the basic operation of RRIFs and the role that RRIFs play in tax planning for retirement (P 10-168 to 10-186).
23. Explain the general rules for Deferred Profit Sharing Plans (P 10-187 to 10-192).
24. Describe, in general terms, Profit Sharing Plans (P 10-193 to 10-196).
25. Describe the tax free transfers that can be made between various types of plans (P 10-197 and 10-198).

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26. Apply the special rules associated with RRSP contributions and retiring allowances (P 10-199 and 10-200).
27. Explain the general provisions related to Retirement Compensation Arrangements (P 10-201 to 10-210).
28. Describe Salary Deferral Arrangements (P 10-211 to 10-218).

# CHAPTER 11

## How To Work Through Chapter 11

We recommend the following approach in dealing with the material in this Chapter:

**Taxable Income Introduction And Overview**

- Read paragraph 11-1 to 11-7 (in the textbook).

**Lump-Sum Payments**

- Read paragraph 11-8 to 11-13.

**Loss Carry Over Provisions, Listed Personal Property Losses**

- Read paragraph 11-14 to 11-35.
- Do Exercise Eleven-1 (in the textbook) and check the solution in this Study Guide.

**Non-Capital Losses**

- Read paragraph 11-36 to 11-38.
- Do Exercise Eleven-2 and check the solution in this Study Guide.
- Read paragraph 11-39 to 11-40.

**Net Capital Losses (Including Special Rules At Death)**

- Read paragraph 11-41 to 11-49.
- Do Exercise Eleven-3 and check the solution in this Study Guide.
- Read paragraph 11-50 to 11-54.
- Do Exercise Eleven-4 and check the solution in this Study Guide.

**Allowable Business Investment Losses (ABILs)**

- Read paragraph 11-55 to 11-62.
- Do Exercise Eleven-5 and check the solution in this Study Guide.
- Do Self Study Problem Eleven-1 which is available on MyLab and check the solution in this Study Guide.

**Farm Losses**

- Read paragraph 11-63 to 11-67.
- Do Exercise Eleven-6 and check the solution in this Study Guide.
- Do Self Study Problem Eleven-2 and check the solution in this Study Guide.

**Lifetime Capital Gains Deduction**

- Read paragraph 11-68 to 11-85.
- Do Exercise Eleven-7 and check the solution in this Study Guide.
- Read paragraph 11-86 to 11-93.
- Do Exercise Eleven-8 and check the solution in this Study Guide.
- Do Self Study Problem Eleven-3 and check the solution in this Study Guide.

### Ordering Of Deductions And Losses

- Read paragraph 11-94 to 11-103.
- Do Exercise Eleven-9 and check the solution in this Study Guide.

### Tax Payable Overview And Tax On Split Income (TOSI)

- Read paragraph 11-104 to 11-147.
- Do Exercise Eleven-10 and check the solution in this Study Guide.
- Do Self Study Problem Eleven-4 and check the solution in this Study Guide.

### Transfer Of Dividends To A Spouse Or Common-Law Partner

- Read paragraph 11-148.
- Do Exercise Eleven-11 and check the solution in this Study Guide.
- Do Self Study Problems Eleven-5 and Eleven-6 and check the solutions in this Study Guide.

### Charitable Donations Credit - Gifts Of Capital Property

- Read paragraph 11-149 to 11-166.
- Do Exercise Eleven-12 and check the solution in this Study Guide.
- Read paragraph 11-167.
- Do Exercise Eleven-13 and check the solution in this Study Guide.
- Read paragraph 11-168 to 11-174.

### Foreign Tax Credits Revisited

- Read paragraph 11-175 to 11-186.
- Do Exercise Eleven-14 and check the solution in this Study Guide.

### Alternative Minimum Tax (AMT)

- Read paragraph 11-187 to 11-200.
- Do Exercise Eleven-15 and check the solution in this Study Guide.

### Comprehensive Tax Payable And Sample Personal Tax Return For Chapter 11

- Read paragraph 11-201.
- Do Self Study Problems Eleven-7 to Eleven-11 and check the solutions in this Study Guide.
- Read the Sample Personal Tax Return For Chapter 11 found in this Chapter of this Study Guide. The complete tax returns are available on MyLab in two formats, a T1 ProFile return file and a .PDF file.

### Tax Software Self Study Problem

- Do Tax Software Self Study Problem - Chapter 11 using the ProFile T1 Software. The Self Study Case is found in this Chapter of this Study Guide. The complete tax return is available on MyLab.

### To Complete This Chapter

- If you would like more practice in problem solving, do the Supplementary Self Study Problems for the chapter. These are available on MyLab.
- Review the Key Terms Used In This Chapter in the textbook at the end of Chapter 11. Consult the Glossary for the meaning of any key terms you do not know.
- Test yourself with the Chapter 11 Glossary Flashcards on MyLab.
- Ensure you have achieved the Chapter 11 Learning Objectives listed in this Study Guide.
- As a review, we recommend you view the PowerPoint presentation for Chapter 11 that is on MyLab.

### Practice Examination

- Write the Practice Examination for Chapter 11 that is on MyLab. Mark your examination using the Practice Examination Solution that is also on MyLab.

# Sample Personal Tax Return For Chapter 11

The following example contains a T1 individual income tax returns completed using the ProFile T1 Personal Income Tax Program for 2018 tax returns from Intuit Canada. As software for 2019 is not yet available, this example contains 2018 rates and credits.

The updated 2019 filing version of the ProFile software will be available in January, 2020. Non-filing versions will be available prior to that date, but include a number of 2019 draft forms that have not yet been updated. On installation, the program defaults to check for updates, so non-filing versions may be installed automatically. In January, 2020, after the first 2019 filing version is released, the updated 2019 version of this sample return will be available on MyLab at:

**http://www.pearsonmylabandmastering.com**

This example was introduced in Chapter 4 and is expanded in Chapter 11 to contain other components of Taxable Income and Tax Payable. For comparison purposes, you might find it useful to review the Chapter 4 version of this example before proceeding with this version.

In the following example, the relevant T1 schedule or ProFile form name is provided in square brackets to indicate where the information is input.

## Sample Problem Data

**DISCLAIMER:** All characters appearing in this example are fictitious. Any resemblance to real persons, living or dead, is purely coincidental.

George Pilot (SIN 527-000-145) is a married, semi-retired air force pilot living in Banff, Alberta. His wife, Deborah (SIN 130-692-544) was mauled by a grizzly bear while hiking 3 years ago. The attack left her blind and limited her mobility. [Part A S2 - Yes to disability amount. Part B, check appropriate box on the Info form on Deborah's return under Filing.]

They have been your clients for many years. George was born on February 24, 1967 and Deborah was born on April 10, 1971. They are both Canadian citizens.

After some discussion with George and Deborah, you confirm that they have never owned any foreign property. They both authorize the CRA to provide information to Elections Canada and authorize you to e-file their returns. They are currently living at 69 BBB Street in Banff, Alberta T9Z 0C0. Their home phone number is (403) 111-1111.

George and Deborah have three children who are all in good health:

- Bryan (SIN 527-000-947) was born on March 12, 2011 and had no income during the year.
- Janice (SIN 527-000-269) was born on June 6, 2005 and is in high school. She had income from babysitting totalling $400 during 2018.
- Willa (SIN 527-000-228) was born on January 22, 1999 and is attending university in Edmonton. Willa had Net Income of $3,300 during 2018.

George has a passion for flying and was hired in February to fly fire bombers June 1 to September 30 for the provincial forest service fire control squad located in Banff.

George informs you that on February 12, 2018, he received $2 million from his mother's estate. Using some of these funds, George bought a house in Banff. The remainder of the funds were invested with his stockbroker, $$$$ Inc.

Deborah, a voice teacher, adapted to her blindness quickly and required no outside help to take care of the family last year or for the first eight months of 2018. She decided to move temporarily to Edmonton with Willa to attend the music program at the University of Alberta.

During 2018, Deborah made a $50,000 loan to her brother, Andrew, who used the funds to expand his business. On December 15, 2018, Andrew paid her interest of $1,500 and principal of $5,000. Also during 2018, Deborah gave private voice lessons and earned a total of $3,200 in teaching fees. [S2 for Deborah's income in Part A. In Part B, Deborah's income is on S4 and T2125.]

George brings you the following receipts and documents:

1. A T4, T4A and a T5 (included in this example). A statement from his bank stating that he paid $7,382 in interest on the mortgage on his house during 2018. (See Items 17 and 23.)
2. A T2202A "Tuition And Enrollment Certificate" for himself from Athabasca University. It showed he was a part time student for 6 months and paid $591 in tuition for 2018. [T2202]
3. Two charitable donation receipts. One in George's name for $1,000 from the Canadian Wildlife Federation dated April 10, 2018. A second receipt in Deborah's name for $100 from the Canadian National Institute for the Blind (CNIB) dated December 3, 2018. [Donations]
4. A statement from the Banff Dental Clinic that George paid a total of $1,650 during 2018. This consisted of $850 for himself on November 24, and $200 each for Deborah, Bryan, Willa and Janice on December 15. [Medical]
5. An invoice from the CNIB in Deborah's name for $375 dated December 26, 2018 for computer peripherals designed exclusively for a person who is blind to use a computer. She had obtained a prescription from her doctor specifying her need for this equipment. [Medical]
6. George spent $14,700 during 2018 on various permanent modifications to the house. His goal for these changes was to allow Deborah to be more mobile inside and outside the house (ex., outside ramps and railings in the halls and stairways) and to reduce the risk of harm to her (a walk-in bathtub). George has detailed invoices for the renovations. Since Deborah's mobility impairment is not severe, these expenditures do not qualify as allowable medical expenses. [Schedule 12]
7. An agreement of purchase and sale for a house at 69 BBB St. in Banff. The purchase price was $800,000 and the invoice for legal fees totalled $1,200. The deal closed March 31, 2018 and George paid the purchase price of the house in cash. George and his family had been living in a rented townhouse for the last 5 years. Prior to that George had owned a house, but it went to his ex-wife in the divorce settlement. Deborah has never owned a principal residence. [OtherCredits for the Home Buyers' Credit.]
8. An instalment statement for 2018 that showed that George had paid the CRA instalments of $1,500 on September 14 and December 14 ($3,000 in total). These were the instalments requested by the CRA for the year due to his self-employed income in the previous year. [OtherCredits]
9. A T2202A "Tuition And Enrollment Certificate" for Deborah from the University of Alberta. It showed she was a full time student for 4 months and paid $2,600 in tuition for 2018. [S2 in Part A, Deborah's T2202 in Part B.]
10. A T2202A "Tuition And Enrollment Certificate" for Willa from the University of Alberta. It showed she was a full time student for 8 months and paid $6,200 in tuition for 2018. She had signed the certificate authorizing the maximum transfer of her tuition amount to her father. [Dependant]
11. His 2017 Notice of Assessment that shows that his 2018 RRSP Deduction Limit is $13,979. He has no undeducted RRSP contributions from previous years. [RRSP]
12. A contribution receipt to a spousal RRSP (George contributed to Deborah's RRSP) for $2,000 from $$$$ Inc. dated February 20, 2019. [RRSP]

13. A receipt for $2,000 from George's 40 year old sister, Shirley Burns (SIN 527-000-582) for child care. She took care of Bryan after school during 2018 while Deborah was in Edmonton. [Input on Dependants, flows to T778]

14. A receipt for Janice, an accomplished trombone player, from the Peak Music Camp in Whistler, B.C. The receipt for $1,600 was for two weeks of intensive music instruction at the camp. This fee also included $400 in accommodations and $325 for meals. [Input on Dependants, flows to T778]

15. A receipt for $2,148 from the Mountain Moving Company dated April 1, 2018. The invoice showed that the fee was charged to pack and move George's household effects from 123 CCC Avenue, Calgary to his new house in Banff, a total of 125 kilometers. George's new home is 5 kilometers from the Alberta Fire And Brimstone Control offices. George and his family made the move in his truck. Since George has no travel receipts, he agrees that you should use the simplified method to calculate his moving costs. [T1M]

16. In July, 2018, George asked you how much he could contribute to TFSAs for himself, and Deborah. By accessing their accounts through the CRA's online Represent A Client service, you informed him that he could contribute $25,000 for both himself and Deborah. George brings in TFSA Statements for himself and Deborah that shows he made the maximum contribution to each TFSA on October 20, 2018. It also shows that Deborah withdrew $3,000 from her TFSA on December 15, 2018.

17. George's new stockbroker, Mr. Ace Securities at $$$$ Inc., convinces him to take out a mortgage on his new home in order to invest the funds in various stocks. George assumes a $500,000 mortgage as of June 1, 2018. On that date, the funds from his mortgage are transferred to $$$$ Inc. into a trading (i.e., non-registered) account. The $7,382 mortgage interest on the bank statement relates to this mortgage. The stockbroker assures George that the funds will remain fully invested in the trading account. [S4]

18. George's transaction summary statement from $$$$ Inc. for 2018 lists the details of 33 sales of stock in George's trading account. The net result, after commissions, is a capital gain of $4,072. [S3Details]

19. On January 8, 2018, George sold his 1971 Ford Mustang for $50,000. The car was driven only on sunny Sunday afternoons. Its original price in 2002 was $6,000, and George reconditioned it over the years at a cost of $12,000. [S3Details]

20. At the beginning of 2018, George has a net capital loss carry forward of $2,580 [(1/2)($5,160)] from 2016. [LossNetCap]

21. During 2018, he paid $6,000 in spousal support to his ex-wife, Marilyn (SIN 527-000-103), pursuant to a written agreement. [Support payments]

22. George owns a commercial property at 999 JJJ Avenue, Edmonton, Alberta T9Z 0C0. The property was 10 years old when he purchased it on February 15, 2016 for $600,000 of which $160,000 was allocated to the land. Shortly after George purchased the building, the major tenant went bankrupt and he had rental losses for 2016 and 2017. No capital additions were made since the building's acquisition. The financial information for the property, for the year ended December 31,2018, is as follows [Rental]:

| | |
|---|---|
| Rental income | $46,700 |
| Mortgage interest | $19,500 |
| Maintenance and repairs | 5,100 |
| Management and administration fees | 8,200 |
| Legal fees | 1,000 |
| Property taxes | 11,750 |
| Total expenses | $45,550 |
| Net Income before amortization | $ 1,150 |

23. In Calgary in prior years, George gave the occasional private flying lesson and found it very rewarding. After moving to Banff, he began to pursue private pilot training in earnest beginning April 1 through his business, Pilot's Flying School. A portion of his new house is used exclusively for various training activities such as one-to-one ground instruction. He also writes and reviews practice pilot exams. George's fiscal year end for the business is December 31.

    The business area of the house occupies 420 square feet of the 2,100 square foot house. George does not intend to claim any CCA on the house. At your request he provides the following costs related to the house during the period April 1, 2018 through December 31, 2018 [T2125]:

| | |
|---|---|
| Utilities | $1,500 |
| Repairs And Maintenance | 4,325 |
| Home Insurance | 700 |
| Mortgage Interest | 7,382 |
| Property Taxes | 2,600 |

24. On April 15, 2018, George purchased a laptop computer and various software that will be used solely for his business activities. The laptop cost $1,900 and the software costs totalled $800. Prior to this, George had not been using a computer for business purposes. [T2125]

25. George provides the following other information for Pilot's Flying School, for the fiscal period ended December 31, 2018:

| | |
|---|---|
| Lesson and training fees received | $40,200 |
| Plane rental fees | 9,600 |
| Business meals with clients | 3,250 |
| Licenses and fees | 1,650 |
| Office expenses | 550 |
| Accounting fees | 300 |

## Completed Tax Returns And Related Notes

There are three sample tax returns available on MyLab in two versions, a T1 ProFile return file and a .PDF file. Notes to the returns are in a separate .PDF file.

A. A single return assuming George does not elect to pension income split and Deborah does not file a tax return.
B. A coupled return assuming George elects to split his pension income with Deborah and she files a tax return as well.

## Notes To The Chapter 11 Return - No Pension Splitting

### *Only George Is Filing A Return*

### *General Notes*

- Inheritances are not taxable.
- Willa's tuition fees total more than $5,000. As a result, her transfer to George is limited to the $5,000 maximum. Only Willa can claim the unused credits in the future. Willa should file a return in order to receive the GST credit and to help her keep track of her tuition credit carry forward.
- Since Willa is over 17 years of age, her medical expenses are reduced by 3 percent of her Net Income For Tax Purposes.
- George is not eligible for the refundable medical expense supplement or the Canada Workers Benefit as his income is too high. Given 3 percent of his Net Income is greater than the medical expense threshold, the only allowable medical expenses are those of Willa. In the ProFile tax file there is a memo attached to the line "Total medical expenses -

line 330" (green highlight) that says "Net Income too high, do not claim medical expenses except for Willa so carry forward is optimized". Since they were paid in November and December, they could be claimed in the following year if the 12 month limit is used.
- Deborah has interest income of $1,500 and professional fees of $3,200. As a result, the spousal credit base is decreased by this amount on Schedule 2. Note that the principal repayment of $5,000 is not income. Deborah's disability credit has been transferred to George, as well as all of her tuition tax credit since it totals less than $5,000.
- George does not qualify for the Climate Action Incentive (CAI) as a resident of Alberta. This is a refundable credit available to residents of Ontario, Saskatchewan, Manitoba and New Brunswick and is based on family size.

### *Item Specific Notes*

- (Item 3) For couples, the CRA's administrative practices permit either spouse to claim some or all of the donations made by the couple. George should claim both donations as combining them is advantageous given the 15 percent rate on the first $200 of donations.
- (Item 5) Both ITA 118.2 and Income Tax Folio S1-F1-C1 clearly state that medical expenses can only be deducted by the individual who paid for them. However, in the T1 Guide, this rule is contradicted for couples. According to this Guide, either spouse can claim the medical expense credit, without regard to who actually paid for the expenses. This administrative position is used in practice. As a result, George is claiming the amount Deborah paid for the computer peripherals.
- (Item 6) George's receipts for the expenses eligible for the Home Accessibility Credit total more than the $10,000 maximum for the year on Schedule 12. As a result the maximum credit of $1,500 [(15%)($10,000)] is available.
- (Item 7) The Home Buyers' Tax Credit of $750 [(15%)($5,000)] is available since George had been living in a rented town house for 5 years and neither he nor Deborah had another principal residence.
- (Items 13 and 14) Since Deborah was in full time attendance at the University of Alberta, George can deduct child care costs of up to $4,000 [(2)($125)(16 weeks)]. The $2,000 paid to Shirley Burns is totally deductible. The deduction for child care costs is limited to $125 per week for overnight camp fees. This results in maximum deductible child care costs of $2,250.
- (Item 15) Form T1M, Claim For Moving Expenses should be filled out to calculate the deductible moving expenses. George cannot deduct the legal fees related to the purchase of his new home because he had been living in a rented townhouse in Calgary. On Form T1M, since the "Simplified Method" box is checked, the program calculates the allowable deduction for milage using the 2018 Alberta rate on Line 2.
- (Item 17) The house was purchased for cash and the mortgage was obtained for investment purposes only. As a result all of the interest is deductible on Schedule 4. In order that all of the interest remains deductible in the future, George should ensure that the $500,000 from the mortgage remain invested and is not used for personal purposes.
- (Item 18) As long as the transaction summary from the bank is available if requested by the CRA, it is not necessary to list separately each stock sale. Only the net capital gain needs to be input on S3Details.
- (Item 20) George has claimed his net capital loss carry forward of $2,580 as his total taxable capital gains were well in excess of this amount.
- (Item 22) Since the rental property has been showing a loss since its acquisition, no CCA could have been taken prior to 2018. As a result, the beginning of the year UCC of the building will be George's original allocation of $440,000 ($600,000 - $160,000 land cost). The CCA for 2018 is limited to $1,150, the amount that reduces his rental income to nil.

### *T2125 (Items 24 to 26)*

- The Industry Code must be chosen from the list near the top right corner of the T2125. The appropriate choice is 611690, "All Other Schools And Instruction".
- The mortgage interest is not included in the workspace in the home costs. The house was purchased for cash and the mortgage was obtained for investment purposes only and is not a cost of maintaining the house. As a result all of the interest is deductible on Schedule 4. (See Item 17)
- The non-deductible portion of business meals of $1,625 (50% of $3,250) has been excluded.
- The laptop computer has been allocated to CCA Class 50 (55 percent). The software has been allocated to CCA Class 12 (100 percent). Because of the short fiscal year, the CCA has been prorated beginning April 1, the start of the business, not the date of the purchase of the assets. The assets aren't eligible for the accelerated investment incentive because they are purchased prior to November 21, 2018.

### *Tax Planning Points*

- If he has sufficient funds, George should contribute the maximum deductible for 2019 of $16,810 [see RRSPLimit form] to a spousal RRSP as soon as possible. Since George is already getting a pension and Deborah appears to have little income, a spousal RRSP would offer more opportunity for future income splitting. Although the pension income splitting legislation allows for some flexibility, the maximum split is 50 percent. With a spousal RRSP, Deborah can be taxed on 100 percent of the funds from her RRSP.
- George should consider opening RESPs for Bryan and Janice if he has not already done so. How much he should contribute will depend on many factors (see the text), but it is probably advisable that he contribute enough to take advantage of the Canada Education Savings Plan each year if he has sufficient funds.
- Deborah has created some RRSP contribution room with her professional income. George should consider whether Deborah should contribute to her own RRSP. Funds for George's RRSP and the RESPs should probably have priority given George's higher tax bracket and the Canada Education Savings Plan, though with his inheritance there should be sufficient funds to contribute to all the plans.
- Since TFSA contributions are not deductible and withdrawals are not taxable, the TFSAs will not have an effect on any of the tax returns. George should try to contribute the maximum to both his and Deborah's TFSA on an ongoing basis if he has sufficient funds. He should replace Deborah's withdrawal as soon as possible as it was withdrawn in the preceding calendar year. As long as there are other funds available where related income would be taxable, it would be advisable not to make withdrawals from the TFSAs in order to take advantage of the tax free earnings.
- George should consider a TFSA for Willa. If her income is earned income for RRSP purposes, he should also consider contributing to an RRSP in Willa's name.

## Notes To The Chapter 11 Returns - With Pension Splitting

### *Both Are Filing Returns With Pension Income Splitting*

The notes to the return with no pension income splitting are also relevant in this scenario.

In creating Deborah's tax return, the following forms and schedules were filled in:

- T2202 - Tuition slips
- T2125 - Statement of Business or Professional Activities
- T1032 - Joint Election To Split Income (originated from George's return)
- Schedule 4 - Statement of Investment Income

Neither Deborah or George should claim the medical expenses, other than George claiming the medical expenses for Willa. Although 3 percent of Deborah's Net Income is less than the threshold, which would enable her to make a claim where George cannot, the tuition fee credit is calculated before consideration of medical expenses, so the claim for medical expenses has no effect on her Tax Payable and does not save her any taxes.

To test this, click Yes that Deborah should claim the medical expenses. What you will find is that her total non-refundable tax credits are greater than her tax payable because her tuition tax credit does not change. This means that the medical expense credit would be wasted. Since they were paid in November and December, they could be claimed in the following year if the 12 month limit is used. On the medical expenses list subtotal in both returns is a memo not to claim any of the listed medical expenses, but to carry them forward in case they make a difference in the following year.

Willa's medical expenses could have been claimed by Deborah, but since it will make no difference to her federal tax payable, it is more advantageous to have George claim Willa's medical expenses.

In addition, although we do not cover provincial tax rules in the text, if you examine Deborah's Alberta tax credits [AB428], you will see that she does not utilize all of her non-refundable Alberta tax credits, even if she does not claim any medical expenses. Claiming Willa's medical credit will decrease George's Alberta and federal tax payable.

Since the couple has elected to split the pension income, the withholdings on the pension income must also be split.

The tax savings can be calculated by comparing the Tax Summary for the couple with and without pension income splitting.

| | |
|---|---|
| Combined Balance Owing - No Pension Splitting | $ 814 |
| Combined Refund - With Pension Splitting | 751 |
| Tax Savings | $1,565 |

## Tax Software Self Study Problem - Chapter 11

**This Problem is an expansion of the Tax Software Self Study Problem - Chapter 4.**

**Note** The following problem contains 2018 (not 2019) information as software for 2019 is not yet available. If you have an updated 2019 version of ProFile installed on your computer, ensure that when you begin, you open a file for 2018, not 2019 as this data is for 2018. Shortly after the first filing version of the 2019 Intuit ProFile software is available in January, 2020, the updated 2019 version of this problem will be available on MyLab at:

**http://www.pearsonmylabandmastering.com**

**DISCLAIMER:** All characters appearing in this problem are fictitious. Any resemblance to real persons, living or dead, is purely coincidental.

Ms. Eleanor Victoria's husband died two years ago. After her husband died, she moved from her house in Prince George, B.C., to a rented house in Victoria, B.C.

Ms. Victoria's widowed mother, Marjorie Vancouver lives with Ms. Victoria and takes care of the house, Ms. Victoria's younger daughter, Amy, and all of the household cooking. In addition to OAS benefits, Marjorie has a very small income from her deceased husband's life insurance policy. She has never filed a tax return and she is not infirm.

Diane Victoria, Eleanor's older daughter, is studying psychology at McGill University in Montreal. Her field is addiction research with a special emphasis on gambling. She does volunteer work at a gambling addiction treatment centre in Montreal in the summers. As Eleanor has paid for her tuition and living costs, Diane has agreed that the maximum tuition amount should be transferred to her mother.

Diane has decided not to file a tax return this year as she knows she does not owe any taxes. Her income was earned driving for a client of the addiction treatment centre who had lost his licence after being charged with impaired driving.

Late in December, 2018, Eleanor was notified that she had inherited $500,000 from an aunt. Eleanor loves her work and though she plans to travel more, she has no plans to retire.

Information concerning Ms. Victoria for 2018 is given on the following pages.

**Required**:

A. With the objective of minimizing Ms. Victoria's Tax Payable, prepare the 2018 income tax return of Eleanor Victoria using the ProFile tax software program. List any assumptions you have made, and any notes and tax planning issues you feel should be discussed with Ms. Victoria. Ignore HST implications in your solution by assuming that Ms. Victoria does not qualify for the GST/HST rebate.

B. Calculate the maximum deductible contribution Ms. Victoria can make to her RRSP for the 2019 taxation year. What advice would you give Ms. Victoria concerning the various deferred savings plans available to her given the funds from her inheritance?

| Personal Information | |
|---|---|
| Title | Ms. |
| First Name | Eleanor |
| Last Name | Victoria |
| SIN | 527-000-087 |
| Date of birth (Y/M/D) | 1971-05-15 |
| Marital Status | Widowed |
| Canadian citizen? | Yes |
| Provide information to Elections Canada? | Yes |
| Own foreign property of more than $100,000 Canadian? | No |

| Taxpayer's Address |
|---|
| 111 VVV Street Victoria, B.C. V4H 3W4 |
| Phone number (250) 111-1111 |

| Dependants | Child 1 | Child 2 | Mother |
|---|---|---|---|
| First Name | Diane | Amy | Marjorie |
| Last Name | Victoria | Victoria | Vancouver |
| SIN | 527-000-293 | None | 527-000-483 |
| Date of birth (Y/M/D) | 1998-05-14 | 2006-10-11 | 1946-05-21 |
| Net income | $2,300 | Nil | $8,000 |

| T4 | Box | Amount |
|---|---|---|
| Issuer - 1750 Canada Inc. | | |
| Employment income | 14 | 60,201.80 |
| Employee's CPP contributions | 16 | 2,593.80 |
| Employee's EI premiums | 18 | 858.22 |
| RPP contributions | 20 | 2,406.16 |
| Pension adjustment | 52 | 7,829.00 |
| Income tax deducted | 22 | 6,408.00 |
| Employment commissions | 42 | 0 |
| Union dues | 44 | 748.59 |
| Charitable donations | 46 | 175.00 |

Eleanor has a signed T2200 from her employer specifying her work requires her to have an office in the home. She meets the conditions required to deduct work space in the home expenses. Of the 1,800 square feet in the house, her office, waiting area and storage space totals 310 square feet. She doesn't qualify for the GST rebate.

During 2018 she paid the following:

| | |
|---|---|
| Rent for the year (No GST charged) | $30,000 |
| Utilities (hydro and gas) for the year | 2,500 |
| Cleaning services (No GST charged) | 1,200 |
| Insurance for household effects (No GST charged) | 400 |
| Car insurance (No GST charged) | 700 |

| T2202A - (Diane) | Box | Amount |
|---|---|---|
| Tuition fees - for Diane Victoria (daughter) | A | 7,000 |
| Number of months in school - part-time | B | 2 |
| Number of months in school - full-time | C | 8 |

Eleanor and her family had the following medical expenses, all of which Eleanor paid for:

| Patient | (Y/M/D) | Medical Expenses | Description | Am't |
|---|---|---|---|---|
| Eleanor | 2018-08-15 | Grace Hospital | Ambulance charge | 392 |
| Eleanor | 2018-08-18 | Paramed Home Health | Nursing care | 1,350 |
| Marjorie | 2018-05-20 | Dr. Zhang (Optometrist) | Contact lenses | 110 |
| Marjorie | 2018-07-06 | Pharmacy | Prescription | 75 |
| Diane | 2018-09-01 | Dr. Glassman | Physiotherapist | 100 |
| Amy | 2018-05-11 | Walk Right Foot Clinic | Orthotics | 450 |
| Amy | 2018-01-23 | Dr. Tamo | Dental Fees | 1,120 |

| Donor | Charitable Donation Receipts | Am't |
|---|---|---|
| Eleanor | Heart and Stroke (annual donation) | 375 |
| Eleanor | Terry Fox Foundation (annual donation) | 50 |
| Diane | Addiction Research Council of Canada (annual donation) | 100 |

| T3 | Box | Amount |
|---|---|---|
| Issuer - Global Strategy Financial | | |
| Foreign country - United States | | |
| Capital gains (Foreign) | 21 | 982.22 |
| Foreign non-business income | 25 | 310.94 |

| T4A | Box | Amount |
|---|---|---|
| Issuer - 3601 Canada Inc. (Survivor benefit from husband) | | |
| Pension | 16 | 22,249.44 |
| Income tax deducted | 22 | 3,510.78 |

| T4A(P) | Box | Amount |
|---|---|---|
| Survivor benefit | 15 | 4,823.28 |
| Income tax deducted | 22 | Nil |

| T5 | Box | Slip 1 | Slip 2 |
|---|---|---|---|
| Issuer | | Scotia Bank | Bank of Montreal |
| Actual amount of eligible dividends | 24 | | 1,603.00 |
| Taxable amount of eligible dividends | 25 | | 2,212.14 |
| Interest from Canadian sources | 13 | 509.45 | |

| RRSP information | (Y/M/D) | Amount |
|---|---|---|
| Issuer of receipt - Scotia Bank | 2019-02-10 | 2,620.00 |
| Earned income for 2017 | | 38,873.00 |
| Pension adjustment for 2017 | | 4,376.00 |
| Unused deduction room at the end of 2017 | | 1,666.00 |

| Child | Child Care Expenses | No. of weeks | Amount |
|---|---|---|---|
| Amy | Croft Computer Camp (14 days overnight) | 2 | 1,000 |
| Amy | Y Day Camp (July) | 3 | 400 |

Eleanor did not sell her house in Prince George when she moved to Victoria as it was her intention to move back into it within 3 years. It has been rented on a month-to-month lease since November, 2017. She claimed a rental loss of $4,250 in 2017.

| Real Estate Rental | Amount |
|---|---|
| Address - 222 PPP Street, Prince George, B.C. V4H 3W4 | |
| Gross rents (12 months for 2018) | 15,600.00 |
| Property taxes | 2,190.00 |
| Insurance | 1,093.27 |
| Interest on mortgage | 5,377.58 |
| Payment on principal | 3,688.95 |
| Plumbing repairs | 290.94 |
| Snow plow annual contract | 300.00 |
| Lawyer's fees for new lease | 172.54 |
| Hydro (during vacancy) | 288.34 |
| Building purchased October 1, 2015 for $168,900 - UCC beginning of year | 168,900.00 |
| Washer/dryer purchased May 9, 2017 for $921 - UCC beginning of year | 921.00 |
| Stove and refrigerator purchased August 17, 2018 | 1,500.00 |

## Solutions to Chapter Eleven Exercises

### *Exercise Eleven - 1 Solution*

Mr. Smothers will have a listed personal property loss carry forward from 2018 of $5,500 [(1/2)($89,000 - $100,000)]. This can only be applied against the 2019 taxable gain on listed personal property of $2,000 [(1/2)($5,000 - $1,000)]. Based on this, his Net and Taxable Income would be calculated as follows:

| | |
|---|---|
| Income Under ITA 3(a) | $62,000 |
| Income Under ITA 3(b) ($2,000 - $2,000) | Nil |
| Net Income For Tax Purposes And Taxable Income | $62,000 |

In this case, the listed personal property loss carry forward of $3,500 ($5,500 - $2,000) can only be applied against taxable capital gains on listed personal property.

If the sale had been of shares, Mr. Smothers would have had a regular net capital loss carry forward of $5,500 from 2018. His Net and Taxable Income would be calculated as follows:

| | |
|---|---|
| Income Under ITA 3(a) | $62,000 |
| Income Under ITA 3(b) | 2,000 |
| Net Income For Tax Purposes ($2,000 Higher) | $64,000 |
| Loss Carry Forward (Limited To Taxable Capital Gains) | ( 2,000) |
| Taxable Income (Same) | $62,000 |

In this case, the $3,500 net capital loss carry forward can be applied against any taxable capital gains.

### Exercise Eleven - 2 Solution

The required calculation is as follows:

| | |
|---|---|
| Amount E ($58,000 + $2,200) | $60,200 |
| Amount F ($35,000 + $13,000) | ( 48,000) |
| Amount D | ( 2,200) |
| Non-Capital Loss | $10,000 |

Note that this is the excess of the business loss of $58,000, over the $48,000 in positive sources of income for the year. The additional farm loss of $2,200 would be allocated to a separate loss balance. It is included in the E component and then deducted in the D component. Since it is less than $2,500, the farm loss is not restricted and is fully deductible against any type of income.

### Exercise Eleven - 3 Solution

If Laura makes no effort to minimize the net capital loss carry forward, her Net Income For Tax Purposes and Taxable Income would be calculated as follows:

| | |
|---|---|
| Net Taxable Capital Gain | $40,000 |
| Rental Loss | ( 30,000) |
| Net Income For Tax Purposes | $10,000 |
| Net Capital Loss Carry Forward (Taxable Income To Nil) | ( 10,000) |
| Taxable Income | Nil |

This approach results in a net capital loss carry forward of $5,000, and a non-capital loss carry over of nil.

Alternatively, if she chooses to completely eliminate the net capital loss carry forward, the non-capital loss would be calculated as follows:

| | |
|---|---|
| Amount E ($30,000 + $15,000) | $45,000 |
| Amount F - Income Under ITA 3(c) | ( 40,000) |
| Non-Capital Loss Carry Over | $ 5,000 |

While Taxable Income remains unchanged at nil, the net capital loss carry forward has been reduced from $5,000 to nil, with the non-capital loss carry forward increased from nil to $5,000.

### Exercise Eleven - 4 Solution

If Derek was alive, his 2019 taxable capital gain would limit the use of his net capital loss carry forward in 2019. This limitation does not apply in the year of death. To maximize tax savings, his final return should have a Taxable Income of $12,069, the 2019 basic personal amount. This means that $11,731 ($23,800 - $12,069) of the net capital loss carry forward should be deducted. This can be applied against any type of income in 2019. The $8,269 ($20,000 - $11,731) can be carried back to 2018 in an amended return and applied against any type of income.

### *Exercise Eleven - 5 Solution*

The Allowable Business Investment Loss for the year would be calculated as follows:

| | |
|---|---|
| Actual Loss On Disposition | $50,000 |
| Disallowed By Lifetime Capital Gains Deduction Use | ( 26,000) |
| Business Investment Loss | $24,000 |
| Inclusion Rate | 1/2 |
| Allowable Business Investment Loss | $12,000 |

All of the $12,000 can be deducted against Mr. Latvik's employment income. With respect to the disallowed $26,000, it becomes an ordinary capital loss, of which $18,000 can be deducted against the current year's capital gains on the publicly traded securities. This leaves a net capital loss carry over of $4,000 [(1/2)($26,000 - $18,000)].

### *Exercise Eleven - 6 Solution*

It appears that Ms. Bodkin's farming activities are a subordinate source of income. Given this, the deduction of the 2018 loss would be limited to $17,500 [$2,500 + (1/2)($32,500 - $2,500)]. The remaining $18,500 ($36,000 - $17,500) is a restricted farm loss carry forward.

In 2019, $3,500 of this carry forward can be deducted against the 2019 farm income. This leaves a restricted farm loss carry forward of $15,000 ($18,500 - $3,500). Ms. Bodkin's 2019 Net Income For Tax Purposes is $88,500 ($85,000 + $3,500) and her 2019 Taxable Income is $85,000 ($85,000 + $3,500 - $3,500).

### *Exercise Eleven - 7 Solution*

The annual gains limit is **$26,000** ($42,000 - $16,000). This is calculated using the ITA 110.6 formula of A - B where:

The A component of the formula would be equal to **$42,000**, the lesser of:

- $74,000 ($114,000 + $42,000 - $82,000); and
- $42,000.

The B component would be **$16,000**, the sum of:

- $13,000*; and
- $3,000.

*The amount by which $45,000, exceeds $32,000 ($114,000 - $82,000 + $42,000 - $42,000).

Note that the net taxable capital gain on non-qualified property was $32,000 ($114,000 - $82,000). The mechanics of the B component of the formula are such that the first $32,000 of the $45,000 net capital loss deduction was charged against these gains and did not erode the annual gains limit. Only the remaining $13,000 ($45,000 - $32,000) served to reduce the annual gains limit.

To make maximum use of her lifetime capital gains deduction, it would be advisable for Ms. Slovena to deduct only $32,000 of the net capital loss carry forward. If she did this, the B component would be $3,000 and her annual gains limit would increase to $39,000 [$42,000 - (Nil + $3,000)]. Although she would have used $13,000 ($39,000 - $26,000) more of her lifetime capital gains deduction, her tax liability for 2019 would not change and she would have a net capital loss carry forward of $13,000 ($45,000 - $32,000) that could be applied against any type of capital gain for an unlimited period of time.

### Exercise Eleven - 8 Solution

His maximum lifetime capital gains deduction is $223,500, the least of the following:

**Available Deduction** His remaining deduction would be $415,456 ($433,456 - $5,000 - $13,000).

**Annual Gains Limit** In the absence of capital gains on non-qualified property in any of the years under consideration, the simplified version of this calculation can be used. Given this, this limit would be calculated as follows:

| | |
|---|---|
| Qualified Gain [(1/2)($510,000)] | $255,000 |
| Net Capital Loss Deducted [(1/2)($63,000)] | ( 31,500) |
| Annual Gains Limit | $223,500 |

**Cumulative Gains Limit** In the absence of capital gains on non-qualified property in 2012 and 2014, the annual gains limits for 2012 and 2014 would simply be the amount of the taxable capital gains on shares in a qualified small business corporation in those years. Given this, the required calculation would be as follows:

| | |
|---|---|
| Sum Of Annual Gains Limits ($5,000 + $13,000 + $223,500) | $241,500 |
| Previous Years' Capital Gains Deduction ($5,000 + $13,000) | ( 18,000) |
| Cumulative Net Investment Loss | Nil |
| Cumulative Gains Limit | $223,500 |

### Exercise Eleven - 9 Solution

Alan's Net Income For Tax Purposes would be calculated as follows:

| | | |
|---|---|---|
| Income Under ITA 3(a): | | |
| Business Income | $12,000 | |
| Employment Income | 56,000 | |
| Farming Income | 3,500 | $71,500 |
| Income Under ITA 3(b): | | |
| Taxable Capital Gains | | 9,000 |
| Net Income For Tax Purposes | | $80,500 |

Alan's Taxable Income is as follows:

| | |
|---|---|
| Net Income For Tax Purposes | $80,500 |
| Loss Carry Forwards: | |
| Restricted Farm Losses (Limited to farming income) | ( 3,500) |
| Net Capital Losses (Limited to taxable capital gains) | ( 9,000) |
| Non-Capital Losses (All) | ( 36,000) |
| Taxable Income | $32,000 |

**Loss Carry Forwards**

| | |
|---|---|
| • Restricted farm loss carry forward ($8,000 - $3,500) | $ 4,500 |
| • Net capital loss carry forward ($20,000 - $9,000) | $11,000 |
| • Non-capital loss carry forward | Nil |

### Exercise Eleven - 10 Solution

The regular Tax Payable would be calculated as follows:

| | |
|---|---|
| Income Sources: | |
| Taxable Non-Eligible Dividends [(115%)($15,000)] | $17,250 |
| Contract Income | 13,200 |
| Taxable Eligible Dividends [(138%)($8,600)] | 11,868 |
| Deduction For Split Income - Taxable Non-Eligible Dividends | ( 17,250) |
| Net Income For Tax Purposes = Taxable Income | $25,068 |
| Rate | 15% |
| Tax Payable Before Credits | $ 3,760 |
| Basic Personal Credit [(15%)($12,069)] | ( 1,810) |
| Dividend Tax Credit - Eligible Dividends [(6/11)(38%)($8,600)] | ( 1,783) |
| Regular Tax Payable | $ 167 |

The Tax Payable on Split Income would be calculated as follows:

| | |
|---|---|
| Split Income - Taxable Non-Eligible Dividends | $17,250 |
| Rate | 33% |
| Tax Payable Before Dividend Tax Credit | $ 5,693 |
| Dividend Tax Credit [(9/13)(15%)($15,000)] | ( 1,558) |
| Tax Payable On Split Income | $ 4,135 |

The total Tax Payable would be $4,302 ($167 + $4,135).

### Exercise Eleven - 11 Solution

Without the transfer, Mr. Ho's wife would have income of $11,730 [(138%)($8,500)], $339 less than the base for the spousal credit of $12,069. This would result in a small spousal credit of $51 [(15%)($339)]. With the transfer, he would be eligible for the full $1,810, an increase of $1,759 [($1,810 - $51). Given this, the analysis of his position at the federal level is as follows:

| | |
|---|---|
| Additional Taxes On Dividends [(33%)(138%)($8,500)] | $3,871 |
| Increase In Spousal Tax Credit | ( 1,759) |
| Dividend Tax Credit [(6/11)(38%)($8,500)] | ( 1,762) |
| Tax Increase (Decrease) | $ 350 |

As the result of the transfer is a tax increase, the election would not be desirable. With or without the election Mrs. Ho will have no Tax Payable.

### Exercise Eleven - 12 Solution

With the gift being made at $85,000, Ms. Felder will have a taxable capital gain of $11,500 [(1/2)($85,000 - $62,000)], plus recapture of $34,000 ($62,000 - $28,000), for a total Net Income For Tax Purposes of $45,500. Given this, her maximum credit base would be calculated as follows:

| | |
|---|---|
| 75% Of Net Income For Tax Purposes [(75%)($45,500)] | $34,125 |
| 25% Of Taxable Capital Gain [(25%)($11,500)] | 2,875 |
| 25% Of Recaptured CCA [(25%)($34,000)] | 8,500 |
| Charitable Donations Credit Base Limit (Equals Income From Donation) | $45,500 |

Note that, because Ms. Felder's Taxable Income is less than $210,371, the 33 percent tax rate is not relevant in calculating the charitable donations tax credit. This base results in a potential credit of $13,167 [(15%)($200) + (29%)($45,500 - $200)]. While this amount could be used, she does not have sufficient Tax Payable to utilize the whole potential credit. Her federal Tax Payable for the year would be calculated as follows:

| | |
|---|---|
| Tax Before Credits [(15%)($45,500)] | $6,825 |
| Basic Personal Credit | ( 1,810) |
| Federal Tax Payable Before Donations Credit | $5,015 |

In order to reduce her Tax Payable to nil, Ms. Felder should use a sufficient amount of her charitable donations credit base to produce a tax credit of $5,015. To arrive at the credit base that will result in this tax credit, the following equation must be solved for X:

$5,015 = [(15%)($200)] + [(29%)(X - $200)
$5,015 - $30 + $58 = [(29%)(X)]

Solving this equation for X provides a value of $17,390 which equals the amount of her donation that produces the $5,015 [(15%)($200) + (29%)($17,390 - $200)] credit that will reduce her federal Tax Payable to nil. This leaves a carry forward of $67,610 ($85,000 - $17,390).

### *Exercise Eleven - 13 Solution*

As a donation of publicly traded shares is involved, there will be no recognized capital gain on the sale. This means that Mr. Radeem's Taxable Income for 2019 will consist of his employment income of $90,000. The limit for the base of Mr. Radeem's charitable donations tax credit would be $67,500 [(75%)($90,000)]. If he were to use this amount, his 2019 charitable donations tax credit would be $19,547 [(15%)($200) + (29%)($67,500 - $200)]. Note that, because Mr. Radeem's Taxable Income is less than $210,371, the 33 percent tax rate is not relevant in calculating the charitable donations tax credit.

As it would exceed his Tax Payable after other tax credits, Mr. Radeem will not want to deduct the maximum available charitable donations tax credit. Given this, he needs to determine the amount of the credit that will reduce his Tax Payable to nil. This is determined as follows:

| | |
|---|---|
| Tax On First $47,630 | $ 7,145 |
| Tax On Next $42,370 ($90,000 - $47,630) At 20.5 Percent | 8,686 |
| Tax Before Credits | $15,831 |
| Tax Credits (Given) | ( 4,000) |
| Federal Tax Payable Before Donations Credit | $11,831 |

In order to reduce his Tax Payable to nil, Mr. Radeem should use a sufficient amount of his charitable donations credit base to produce a tax credit of $11,831. To arrive at the credit base that will result in this tax credit, the following equation must be solved for X:

$11,831 = [(15%)($200)] + [(29%)(X - $200)
$11,831 - $30 + $58 = [(29%)(X)]

Solving this equation for X provides a value of $40,893 which equals the amount of his donation that will produce the $11,831 [(15%)($200) + (29%)($40,893 - $200)] credit that will reduce his federal Tax Payable to nil. This leaves a carry forward of $69,107 ($110,000 - $40,893).

### *Exercise Eleven - 14 Solution*

Ms. Cheung's Net Income For Tax Purposes and Taxable Income would be calculated as follows:

| | |
|---|---|
| Net Rental Income | $44,000 |
| Net Taxable Capital Gains | 2,500 |
| Foreign Non-Business Income | 3,500 |
| Net Income For Tax Purposes | $50,000 |
| Net Capital Loss Carry Forward | ( 2,500) |
| Adjusted Division B Income | $47,500 |
| Non-Capital Loss Carry Forward | ( 4,000) |
| Taxable Income | $43,500 |

Ms. Cheung's credit for foreign tax paid would be the lesser of the foreign tax withheld of $385 [(11%)($3,500)] and an amount determined by the following formula:

$$\left[\frac{\text{Foreign Non} - \text{Business Income}}{\text{Adjusted Division B Income}}\right][\text{Tax Otherwise Payable}]$$

In this formula, the Adjusted Division B Income would be $47,500 (as shown in the preceding table). Note that, because the non-capital loss is not deducted here, this is not the same as her Taxable Income of $43,500.

Ms. Cheung's Tax Otherwise Payable would be calculated as follows (note that the foreign tax credit is not subtracted in this calculation):

| | |
|---|---|
| Tax Before Credits [(15%)($43,500)] | $6,525 |
| Basic Personal Credit | ( 1,810) |
| Tax Otherwise Payable | $4,715 |

Using this information, the formula amount would be $347 [($3,500 ÷ $47,500)($4,715)]. As this is less than the $385 withheld, this would be the foreign tax credit. Based on this, Ms. Cheung's actual federal Tax Payable would be calculated as follows:

| | |
|---|---|
| Tax Before Credits [(15%)($43,500)] | $6,525 |
| Basic Personal Credit | ( 1,810) |
| Foreign Tax Credit | ( 347) |
| Federal Tax Payable | $4,368 |

### *Exercise Eleven - 15 Solution*

Mr. Blouson's regular Tax Payable would be calculated as follows:

| | |
|---|---|
| Tax On First $47,630 | $ 7,145 |
| Tax On Next $37,370 ($85,000 - 47,630) At 20.5% | 7,661 |
| Total | $14,806 |
| Basic Personal Credit | ( 1,810) |
| Dividend Tax Credit [(6/11)(38%)($20,000)] | ( 4,145) |
| Regular Federal Tax Payable | $ 8,851 |

For alternative minimum tax purposes, his adjusted taxable income would be calculated as follows:

| | |
|---|---|
| Regular Taxable Income | $85,000 |
| 30 Percent Of Capital Gains [(30%)(2)($22,500)] | 13,500 |
| Dividend Gross Up [(38%)($20,000)] | ( 7,600) |
| Adjusted Taxable Income | $90,900 |

Calculation of the alternative minimum tax would be as follows:

| | |
|---|---|
| Adjusted Taxable Income | $90,900 |
| Basic Exemption | ( 40,000) |
| Amount Subject To Tax | $50,900 |
| Rate | 15% |
| Minimum Tax Before Credit | $ 7,635 |
| Basic Personal Credit | ( 1,810) |
| Alternative Minimum Tax | $ 5,825 |

Mr. Blouson would not pay the alternative minimum tax as it is less than the regular Tax Payable. Note that the $50,000 RRSP deduction does not affect the alternative minimum tax calculation.

## Self Study Solution Eleven - 1

The calculation of Miss Atwater's Taxable Income for 2018 would be as follows:

| | |
|---|---|
| Net Rental Income | $34,200 |
| Interest Income | 4,000 |
| Net Income For Tax Purposes And Taxable Income | $38,200 |

The corresponding calculation for 2019 is as follows:

| | | |
|---|---|---|
| Net Rental Income | $ 35,200 | |
| Interest Income | 4,200 | $39,400 |
| Allowable Business Investment Loss [(1/2)($170,000)] | | ( 85,000) |
| Net Income For Tax Purposes And Taxable Income | | Nil |

There is a deemed disposition of the shares for proceeds of nil due to the bankruptcy of the company. As the capital loss relates to the shares of a small business corporation, it is a Business Investment Loss. This means that, in contrast to other types of capital losses, the allowable portion can be deducted against any source of income. The total Allowable Business Investment Loss (ABIL) that is available for deduction in 2019 is $85,000 [(1/2)($170,000)].

As the ABIL was recognized in 2019, it must first be used to reduce that year's income to nil. Note that, because of this rule, she cannot deduct a smaller amount in order to have sufficient income to absorb her basic personal tax credit. This will use up $39,400 of the $85,000 total and leave a balance of $45,600 to be carried over to other years.

In carrying this amount back to 2018, the optimum solution would leave $11,809 of Taxable Income so that Miss Atwater can take advantage of her basic personal tax credit. Note that the calculation of the optimum carry back uses the basic personal amount of the carry back year, not the current year.

This means that she needs a loss carry back deduction of $26,391 ($38,200 - $11,809) in 2018. This deduction will leave a Taxable Income of $11,809. As planned, the federal taxes

on this amount will be eliminated by the basic personal credit.

A carry back of $26,391 to 2018 leaves a carry forward balance of $19,209 ($45,600 - $26,391) to be used in future years.

The undeducted Allowable Business Investment Loss can be deducted against other sources of income in the 10 (not 20) year carry forward period. If it has not been utilized within the 10 years, it then becomes a net capital loss carry forward, deductible for an unlimited number of future periods, but only against net taxable capital gains.

## Self Study Solution Eleven - 2

### *2016 Analysis*

The required information can be calculated as follows:

| | | |
|---|---|---|
| ITA 3(a) | | |
| Business Income | $19,800 | |
| Taxable Dividends [(138%)($1,870)] | 2,581 | $22,381 |
| ITA 3(b) | | |
| Taxable Capital Gains [(1/2)($1,320)] | $ 660 | |
| Allowable Capital Losses [(1/2)($4,620)] | ( 2,310) | Nil |
| ITA 3(c) | | $22,381 |
| ITA 3(d) | | |
| Farm Loss (See Note) | | ( 6,750) |
| Net Income For Tax Purposes And Taxable Income | | $15,631 |

**Note** Dale's farm losses are restricted as follows:

| | | |
|---|---|---|
| Total Farm Loss | | $11,000 |
| Deductible Amount: | | |
| First $2,500 | ($2,500) | |
| One-Half Of $8,500 ($11,000 - $2,500) | ( 4,250) | ( 6,750) |
| Restricted Farm Loss Carry Forward | | $ 4,250 |

As noted in the problem, none of the losses can be carried back before 2016. This would leave the following carry forward balances at the end of 2016:

- Restricted Farm Loss Carry Forward $4,250
- Net Capital Loss Carry Forward ($2,310 - $660) $1,650

### *2017 Analysis*

The required information can be calculated as follows:

| | | |
|---|---|---|
| ITA 3(a) | | |
| Farm Income | $ 2,200 | |
| Taxable Dividends [(138%)($2,351)] | 3,244 | $ 5,444 |
| ITA 3(b) | | |
| Taxable Capital Gains [(1/2)($2,200)] | $ 1,100 | |
| Allowable Capital Losses | Nil | 1,100 |
| ITA 3(c) | | $ 6,544 |
| ITA 3(d) | | |
| Business Loss | | ( 15,400) |
| Net Income For Tax Purposes | | Nil |
| 2016 Net Capital Loss Carry Forward | | ($ 1,100) |
| Taxable Income (Loss) | | Nil |

Since there are taxable capital gains this year, and the problem states that Dale would like to deduct the maximum amount of his net capital loss carry forwards, the net capital loss carry forward of $1,100 is added to the balance of the non-capital loss.

The non-capital loss carry over is calculated as follows:

| | |
|---|---|
| Business Loss | $15,400 |
| 2016 Net Capital Loss Deducted | 1,100 |
| ITA 3(c) Income | ( 6,544) |
| Non-Capital Loss Carry Over For 2017 | $ 9,956 |

The entire non-capital loss carry over could be carried back to 2016, but since Dale requires $15,400 in Taxable Income to fully utilize his tax credits, the maximum carry back to 2016 is $231, calculated as follows:

| | |
|---|---|
| 2016 Taxable Income (As Reported) | $15,631 |
| Non-Capital Loss Carry Back From 2017 | ( 231) |
| 2016 Amended Taxable Income (Minimum) | $15,400 |

This carry back leaves Dale with his required $15,400 in Taxable Income. There would be the following carry forward balances at the end of 2017:

| | |
|---|---|
| • Restricted Farm Loss Carry Forward (Unchanged) | $4,250 |
| • Net Capital Loss Carry Forward ($1,650 - $1,100)] | $ 550 |
| • Non-Capital Loss Carry Forward ($9,956 - $231) | $9,725 |

***2018 Analysis***

The required information can be calculated as follows:

| | | |
|---|---|---|
| ITA 3(a) | | |
| Business Income | $33,000 | |
| Farm Income | 3,465 | |
| Taxable Dividends [(138%)($3,160)] | 4,361 | $40,826 |
| ITA 3(b) | | |
| Taxable Capital Gains [(1/2)($4,400)] | $2,200 | |
| Allowable Capital Losses | Nil | 2,200 |
| Net Income For Tax Purposes | | $43,026 |
| Restricted Farm Loss Carry Forward (Equal To Farm Income) | | ( 3,465) |
| Net Capital Loss Carry Forward (Less Than $2,200) | | ( 550) |
| Non-Capital Loss Carry Forward (All) | | ( 9,725) |
| Taxable Income | | $29,286 |

There would be the following carry forward balance at the end of 2018:

| | |
|---|---|
| • Restricted Farm Loss Carry Forward ($4,250 - $3,465) | $ 785 |

### *2019 Analysis*

The required information can be calculated as follows:

| | | |
|---|---|---|
| ITA 3(a) | | |
| Taxable Dividends [(138%)($5,140)] | | $ 7,093 |
| ITA 3(b) | | |
| Taxable Capital Gains [(1/2)($4,950)] | $ 2,475 | |
| Allowable Capital Losses [(1/2)($15,950)] | ( 7,975) | Nil |
| ITA 3(c) | | $ 7,093 |
| ITA 3(d) | | |
| Business Loss | ($20,900) | |
| Farm Loss | ( 2,200) | ( 23,100) |
| Net Income For Tax Purposes And Taxable Income | | Nil |

The available non-capital loss can be calculated as follows:

| | | |
|---|---|---|
| Business Loss | $20,900 | |
| Farm Loss (Unrestricted) | 2,200 | $23,100 |
| ITA 3(c) Income | | ( 7,093) |
| Non-Capital Loss Carry Over For 2019 | | $16,007 |

Although technically, the farm loss is accounted for separately from the non-capital loss, since the farm loss is less than $2,500 it is treated as an unrestricted farm loss and can be applied against all types of income. ITA 31 states that any loss allowed under that provision is considered an unrestricted loss from a farming business for the year for the purposes of calculating the non-capital loss carryover. As a result, the preceding loss carry over of $16,007 is available for carry back to 2018 to be applied against any type of income.

With respect to the net capital loss of $5,500 ($7,975 - $2,475), there are $1,650 ($2,200 - $550) in taxable capital gains left in 2018 as the basis for a carry back. This means that $1,650 of the 2019 net capital loss can be carried back, leaving $3,850 ($5,500 - $1,650) to be carried forward as a net capital loss balance.

If both the $16,007 non-capital loss and the $1,650 net capital loss were carried back to 2018, the result would be a Taxable Income of $11,629 ($29,286 - $16,007 - $1,650), less than the $15,400 that is required to fully utilize Dale's available tax credits. As the net capital loss can only be deducted to the extent of taxable capital gains, it would be advisable to claim the full amount of this loss carry back. Based on this view, the non-capital loss deduction will be limited to $12,236 ($29,286 - $15,400 - $1,650), an amount that will provide for full use of Dale's 2018 tax credits:

| | |
|---|---|
| 2018 Taxable Income (As Reported) | $29,286 |
| Non-Capital Loss Carry Back From 2019 | ( 12,236) |
| Net Capital Loss Carry Back From 2019 | ( 1,650) |
| 2018 Amended Taxable Income | $15,400 |

These carry backs leave Dale with his required $15,400 in 2018 Taxable Income. There would be the following carry forward balances at the end of 2019:

- Restricted Farm Loss Carry Forward (Unchanged) $ 785
- Net Capital Loss Carry Forward ($5,500 - $1,650)] $3,850
- Non-Capital Loss Carry Forward (Nil + $16,007 - $12,236) $3,771

## Self Study Solution Eleven - 3

To the extent that there has been use of the lifetime capital gains deduction in previous years, business investment losses (BILs) are disallowed. When they are disallowed, they become ordinary capital losses that must be deducted against the current year's taxable capital gains. Given this, the non-disallowed portion of the BIL would be calculated as follows:

| | |
|---|---|
| 2019 BIL Realized ($55,000 - $228,000 - $1,000) | $174,000 |
| BIL Disallowed By Previous Use Of ITA 110.6 ($38,000 + $21,000) | ( 59,000) |
| Remaining Business Investment Loss | $115,000 |
| Inclusion Rate | 1/2 |
| Allowable Business Investment Loss | $ 57,500 |

Using this analysis, Mr. Barkin's minimum Net Income For Tax Purposes and Taxable Income would be calculated as follows:

| | | |
|---|---|---|
| Net Employment Income | | $115,000 |
| Allowable Business Investment Loss | | ( 57,500) |
| Net Taxable Capital Gains: | | |
| Taxable Capital Gain [(1/2)($328,000 - $153,000 - $2,000)] | $86,500 | |
| Allowable Capital Loss (Disallowed ABIL) [(1/2)($59,000)] | ( 29,500) | 57,000 |
| Net Income For Tax Purposes | | $114,500 |
| Lifetime Capital Gains Deduction (Note 1) | | Nil |
| Net Capital Loss Carry Forward Deducted (Note 2) | | ( 13,700) |
| Taxable Income | | $100,800 |

**Note 1** As the only capital gains during 2019 are on qualified property, the simplified formula for the annual gains limit can be used. Given this, the lifetime capital gains deduction is nil, the least of:

| | |
|---|---|
| Amount Available [(1/2)($866,912)]* | $433,456 |
| Amount Used [(1/2)($38,000 + $21,000)] | ( 29,500) |
| Amount Available | $403,956 |

*This is the 2019 limit for gains on dispositions of shares of a qualified small business corporation. For gains on qualified farm or fishing property, the 2019 limit would be $1,000,000.

| | |
|---|---|
| Taxable Capital Gain On Qualified Property | $86,500 |
| Allowable Capital Loss Deducted (Disallowed ABIL) | ( 29,500) |
| ABIL Realized | ( 57,500) |
| Annual Gains Limit Prior To Loss Carry Forward | Nil |
| Net Capital Loss Deducted | ( 13,700) |
| Annual Gains Limit | Nil |

| | |
|---|---|
| Sum Of Annual Gains Limits ($19,000 + $10,500 + Nil) | $29,500 |
| Amounts Deducted In Previous Years ($19,000 + $10,500) | ( 29,500) |
| CNIL | ( 4,800) |
| Cumulative Gains Limit | Nil |

**Note 2** Even without the deduction of the net capital loss carry forward, the annual gains limit was nil, preventing the deduction of any amount for the lifetime capital

gains deduction. Given this, it is appropriate to deduct the net capital loss carry forward.

## Self Study Solution Eleven - 4

### *CASE A*

As Marty is actively engaged in the business on a regular, continuous, and substantial basis, the corporation is an Excluded Business. Given this, Marty's dividends will not be classified as Split Income.

While Miranda is not actively engaged in the business she is over 24 years of age and owns at least 10 percent of both the number of voting rights and the fair market value of the corporation's outstanding shares. In addition, the Company is not a professional corporation, less than 90 percent of its business involves performing services, and substantially all of its income is not from a related business. Given this, she would meet the Excluded Shares test and the dividends she received will not be classified as Split Income.

### *CASE B*

As Jerome is actively engaged in the business on a regular, continuous, and substantial basis, the corporation is an Excluded Business from his point of view. Given this, Jerome's dividends will not be classified as Split Income.

While Jeff has not been active in the business in either 2018 or 2019, he worked full time in the business for more than the required 5 years (2012 through 2017). Given this, the corporation is an Excluded Business and Jeff's dividends will not be classified as Split Income.

### *CASE C*

As Charles is actively engaged in the business on a regular, continuous, and substantial basis, the corporation is an Excluded Business. Given this, Charles' dividends will not be classified as Split Income.

As Clifford has never been actively involved in Clill, it is not an Excluded Business from his point of view. However, Clifford is over 24 years of age and owns more than 10 percent of the number of voting rights and the fair market value of the Clill shares. In addition, Clill is not a professional corporation, less than 90 percent of its business involves performing services, and substantially all of its income is not from a related business. Given this, Clifford's shares would be Excluded Shares and the dividends he received would not be classified as Split Income.

## Self Study Solution Eleven - 5

### *Part A - Taxable Income*

Mr. and Mrs. Hanson's Taxable Income would be calculated as follows:

| | Mr. Hanson | Mrs. Hanson |
|---|---|---|
| Old Age Security Benefits | $ 7,400 | $ 7,400 |
| RRIF Income | 50,000 | Nil |
| Registered Pension Plan Receipts | 25,380 | 1,680 |
| Dividends Received | 800 | 180 |
| Gross Up On Dividends (38 Percent) | 304 | 68 |
| Interest On Government Bonds | 500 | 4,359 |
| Net Taxable Capital Gain | Nil | Nil |
| Net Income Before Clawback | $84,384 | $13,687 |
| Social Benefits Repayment (See Note) | ( 1,021) | Nil |
| Net Income For Tax Purposes And Taxable Income | $83,363 | $13,687 |

**Note** Mrs. Hanson would not have to repay any of her OAS benefits as her Net Income is well below the threshold income of $77,580. Mr. Hanson's social benefits repayment would be the lesser of:

- $7,400, and
- [(15%)($84,384 - $77,580)] = $1,021.

### Part A - Tax Credits

Mr. Hanson cannot take the spousal credit because Mrs. Hanson's Net Income is more than the $12,069 base for this credit. Mrs. Hanson cannot transfer her dividends under ITA 82(3) as the transfer would leave her with Net Income of $13,439 ($13,687 - $180 - $68). This would still be more than the $12,069 base for the spousal credit and, as a consequence, no spousal tax credit would be created. Given these considerations, the amount that can be transferred from Mrs. Hanson to Mr. Hanson is calculated as follows:

| | |
|---|---|
| Age | $7,494 |
| Pension (On RPP Only) | 1,680 |
| Reduced By Mrs. Hanson's Taxable Income In Excess Of Her Basic Personal Tax Credit($13,439 - $12,069) | ( 1,370) |
| Credit Base Transferred To Spouse | $7,804 |

Mr. Hanson's maximum tax credits would be as follows:

| | |
|---|---|
| Basic Personal Amount | $ 12,069 |
| Age $7,494 - [(15%)($83,363 - $37,790)] | 658 |
| Pension | 2,000 |
| Transfers From Mrs. Hanson (See Preceding) | 7,804 |
| Total Base | $22,531 |
| Rate | 15% |
| Total | $ 3,380 |
| Dividend Tax Credit [(6/11)($304)] | 166 |
| Charitable Donations [(15%)($200) + (29%)($600 + $200 - $200)] | 204 |
| Total Credits | $ 3,750 |

Charitable donations can be claimed by either spouse, as long as the total donations are less than 75 percent of the claiming spouse's Net Income For Tax Purposes. As Mrs. Hanson has no Tax Payable, Mr. Hanson will claim her charitable donations. It is usually advantageous for one spouse to claim all the charitable donations if they total more than $200, as the low rate of credit is only applied once. Note that as none of Mr. Hanson's Taxable Income is taxed at the 33 percent federal tax rate, that rate is not relevant to the calculation of his charitable donations tax credit.

### Part A - Loss Carry Overs

Mrs. Hanson's net capital loss of $175 [(1/2)($725 - $375)] can be carried back 3 years and forward indefinitely to be claimed against taxable capital gains.

### Part B - Pension Income Splitting

The optimum use of pension income splitting would accomplish the following objectives:

- it would permit Mrs. Hanson to claim her dividend tax credit,
- it would permit Mrs. Hanson to fully utilize her pension income tax credit,
- it would eliminate Mr. Hanson's OAS clawback, and
- it would enable both Mr. and Mrs. Hanson to be in the same 20.5 percent tax bracket.

## Self Study Solution Eleven - 6

***Part A***

Mr. and Mrs. Dalton's Taxable Income would be calculated as follows:

| | Mr. Dalton | Mrs. Dalton |
|---|---|---|
| Old Age Security Benefits | $ 7,400 | $ 7,400 |
| Registered Pension Plan Receipts | Nil | 62,000 |
| RRIF Income | 1,640 | 12,420 |
| Interest On Government Bonds | 1,420 | 2,580 |
| Eligible Dividends Received | 3,420 | 460 |
| Gross Up On Dividends (38 Percent) | 1,300 | 175 |
| Net Income Before Clawback | $15,180 | $85,035 |
| Social Benefits Repayment (Note 1) | Nil | ( 1,118) |
| Net Income For Tax Purposes And Taxable Income Before Any Transfer Of Dividends | $15,180 | $83,917 |

**Note 1** Mr. Dalton would not have to repay any of his OAS benefits as his Net Income is well below the threshold income of $77,580. Mrs. Dalton's social benefits repayment would be the lesser of:

- $7,400, and
- [(15%)($85,035 - $77,580)] = $1,118.

Mr. Dalton's Tax Payable would be calculated as follows:

| | | |
|---|---|---|
| Federal Tax Before Credits [(15%)($15,180)] | | $2,277 |
| Tax Credits | | |
| Basic Personal | ($12,069) | |
| Other (Transferred To Mrs. Dalton) | Nil | |
| Total Base | ($12,069) | |
| Rate | 15% | ( 1,810) |
| Dividend Tax Credit [(6/11)($1,300)] | | ( 709) |
| Federal Tax Payable | | Nil |

The transfer to Mrs. Dalton would be calculated as follows:

| | | |
|---|---|---|
| Credits Available For Transfer: | | |
| Age | | $ 7,494 |
| Pension (Limited To RRIF Receipts) | | 1,640 |
| Disability | | 8,416 |
| Total Available | | $17,550 |
| Reduced By Excess Of: | | |
| Mr. Dalton's Net Income | ($15,180) | |
| Over Basic Personal Credit Amount | 12,069 | ( 3,111) |
| Available For Transfer To Mrs. Dalton | | $14,439 |

The amount owing for Mrs. Dalton would be calculated as follows:

| | | |
|---|---|---|
| Tax On First $47,630 | $ 7,145 | |
| Tax On Next $36,287 ($83,917 - $47,630) At 20.5 Percent | 7,439 | $14,584 |
| Tax Credits | | |
| Basic Personal | ($12,069) | |
| Spousal Including Extra Infirm Amount ($12,069 +$2,230 - $15,180) | Nil | |
| Additional Caregiver Amount (Note 2) | ( 7,140) | |
| Age {$7,494 - [(15%)($83,917 - $37,790)]} | ( 575) | |
| Pension | ( 2,000) | |
| Transfer From Spouse (Preceding Calculation) | ( 14,439) | |
| Credit Base | ($36,223) | |
| Rate | 15% | ( 5,433) |
| Charitable Donations [(15%)($200) +(29%)($350 + $960 - $200)] (Note 3) | | ( 352) |
| Dividend Tax Credit [(6/11)($175)] | | ( 95) |
| Federal Tax Payable | | $ 8,704 |
| OAS Clawback (Note 1) | | 1,118 |
| Amount Owing - Mrs. Dalton | | $9,822 |

**Note 2** Mr. Dalton's income was below the Canada caregiver income threshold of $16,766. In the absence of the spousal credit, the Canada caregiver amount would have been $7,140. Given this, the additional Canada caregiver amount would be $7,140 ($7,140 - Nil).

**Note 3** Charitable donations can be claimed by either spouse, as long as the total donations are less than 75 percent of the claiming spouse's Net Income For Tax Purposes. As Mr. Dalton has no Tax Payable, Mrs. Dalton will claim his charitable donations. It is usually advantageous for one spouse to claim all the charitable donations if they total more than $200, as the low rate of credit is only applied once. Note that as none of Mrs. Dalton's Taxable Income is taxed at the 33 percent federal tax rate, that rate is not relevant to the calculation of her charitable donations tax credit.

### *Part B - Eligibility For Transfer*

Mrs. Dalton cannot currently take the spousal credit because Mr. Dalton's Net Income is more than the $14,299 ($12,069 + $2,230) base for the credit. However, Mr. Dalton can transfer his dividends under ITA 82(3) as the transfer would leave Mr. Dalton with a Net Income of $10,460 ($15,180 - $3,420 - $1,300). This is below the $14,299 base for the spousal credit and, as a result, the transfer would create a spousal tax credit and is permitted.

### *Part C*

If all of Mr. Dalton's dividends are transferred to Mrs. Dalton, their new Taxable Income figures would be calculated as follows:

| | Mr. Dalton | Mrs. Dalton |
|---|---|---|
| Net Income Before Clawback As Per Part A | $15,180 | $85,035 |
| Dividend Transfer | ( 3,420) | 3,420 |
| Gross Up Transfer | ( 1,300) | 1,300 |
| Net Income After Dividend Transfer Before Clawback | $10,460 | $89,755 |
| Social Benefits Repayment (Note 4) | Nil | ( 1,826) |
| Net Income For Tax Purposes And Taxable Income | $10,460 | $87,929 |

**Note 4** Mr. Dalton would not have to repay any of his OAS benefits as his Net Income is well below the threshold income of $77,580. Mrs. Dalton's social benefits repayment would be the lesser of:

- $7,400, and
- [(15%)($89,755 - $77,580)] = $1,826.

As Mr. Dalton's revised income figure is below the basic personal credit of $12,069, his Tax Payable would continue to be nil. The transfer to Mrs. Dalton would be calculated as follows:

| | | |
|---|---|---|
| Credits Available For Transfer: | | |
| Age | | $ 7,494 |
| Pension (Limited To RRIF Receipts) | | 1,640 |
| Disability | | 8,416 |
| Total Available | | $17,550 |
| Reduced By Excess Of: | | |
| Mr. Dalton's Net Income | ($10,460) | |
| Over Basic Personal Credit Amount | 12,069 | ( Nil) |
| Available For Transfer | | $17,550 |

With respect to Mrs. Dalton, her amount owing would be calculated as follows:

| | | |
|---|---|---|
| Tax On First $47,630 | $7,145 | |
| Tax On Next $40,299 ($87,929 - $47,630) At 20.5% | 8,261 | $15,406 |
| Tax Credits | | |
| Basic Personal | ($12,069) | |
| Spousal Including Infirm Amount | | |
| ($12,069 +$2,230 - $10,460) | ( 3,839) | |
| Additional Caregiver Amount (Note 5) | ( 3,301) | |
| Age {$7,494 - [(15%)($87,929 - $37,790)]} | Nil | |
| Pension | ( 2,000) | |
| Transfer From Spouse (Preceding Calculation) | ( 17,550) | |
| Credit Base | ($38,759) | |
| Rate | 15% | ( 5,814) |
| Charitable Donations [(15%)($200) + | | |
| (29%)($350 + $960 - $200)] | | ( 352) |
| Dividend Tax Credit [(6/11)($175 + $1,300)] | | ( 805) |
| Federal Tax Payable | | $ 8,435 |
| OAS Clawback (Note 4) | | 1,826 |
| Amount Owing - Mrs. Dalton | | $10,261 |

**Note 5** As was the case before the transfer of dividends, Mr. Dalton's income is below the Canada caregiver income threshold of $16,766. In the absence of the spousal credit, the Canada caregiver amount would have been $7,140. Given this, the additional Canada caregiver amount would be $3,301 ($7,140 - $3,839).

### Conclusion

The use of the ITA 82(3) dividend transfer has decreased Mrs. Dalton's federal Tax Payable by $269 ($8,704 - $8,435). However, it has increased her OAS clawback by $708 ($1,826 - $1,118). Since the net effect is an increase in the amount owing of $439 ($10,261 - $9,822), the dividend transfer should not be done.

## Self Study Solution Eleven - 7

The regular Tax Payable calculations would be as follows:

| | Walter | Wendel | Winston |
|---|---|---|---|
| Employment And Business Income | $ 52,100 | $42,300 | $ 41,300 |
| Eligible Dividends Received | 82,300 | Nil | 12,300 |
| Dividend Gross Up (38 Percent) | 31,274 | Nil | 4,674 |
| RRSP Deduction | Nil | ( 27,000) | Nil |
| Taxable Capital Gains | 36,400 | Nil | 226,550 |
| Net Income For Tax Purposes | $202,074 | $15,300 | $284,824 |
| Lifetime Capital Gains Deduction | ( 36,400) | Nil | ( 221,500) |
| Taxable Income | $165,674 | $15,300 | $ 63,324 |
| Federal Tax (Note 1) | $ 35,757 | $ 2,295 | $ 10,362 |
| Basic Personal Credit | ( 1,810) | ( 1,810) | ( 1,810) |
| Dividend Tax Credit (6/11 of Gross Up) | ( 17,059) | Nil | ( 2,549) |
| Regular Federal Tax Payable | $ 16,888 | $ 485 | $ 6,003 |

**Note 1** The federal tax payable, before the dividend tax credit, is as follows:

| | Taxable Income | Federal Tax Calculations | Federal Tax |
|---|---|---|---|
| Walter | $165,674 | $30,535 + (29%)($18,007) | $35,757 |
| Wendel | $ 15,300 | (15%)($15,300) | $ 2,295 |
| Winston | $ 63,324 | $7,145 + (20.5%)($15,694) | $10,362 |

The alternative minimum tax (AMT) calculations would be as follows:

| | Walter | Wendel | Winston |
|---|---|---|---|
| Regular Taxable Income | $165,674 | $15,300 | $ 63,324 |
| 30% Of Capital Gains (Note 2) | 21,840 | Nil | 135,930 |
| Dividend Gross Up | ( 31,274) | Nil | ( 4,674) |
| Adjusted Taxable Income | $156,240 | $15,300 | $194,580 |
| AMT Exemption | ( 40,000) | ( 40,000) | ( 40,000) |
| AMT Base | $116,240 | $ Nil | $154,580 |
| Rate | 15% | 15% | 15% |
| Federal AMT Before Credit | $ 17,436 | $ Nil | $ 23,187 |
| Basic Personal Credit | ( 1,810) | ( 1,810) | ( 1,810) |
| Federal AMT | $ 15,626 | Nil | $ 21,377 |
| Regular Federal Tax Payable | ( 16,888) | | ( 6,003) |
| Additional Tax Required (Note 3) | Nil | Nil | $ 15,374 |

**Note 2** The 30 percent capital gain inclusion can be calculated by taking 30 percent of double the taxable capital gain.

**Note 3** The excess AMT over regular tax payable for Winston can be carried forward for 7 years and applied against any future excess of regular Tax Payable over the alternative minimum tax.

## Self Study Solution Eleven - 8

### *Part A - Net Income For Tax Purposes*

Ms. Worthmore's minimum Taxable Income is calculated as follows:

| | | |
|---|---|---|
| **Employment Income** | | |
| Gross Salary - Intra Graphics | $73,532 | |
| Gross Salary - Lindworth Inc. | 2,500 | |
| RPP Contributions | ( 1,233) | $74,799 |
| **Income From Property** | | |
| Eligible Dividend Attribution (Note One) | $ 182 | |
| Gross Up [(38%)($182)] | 69 | |
| Non-Eligible Dividends From Lindworth | 4,325 | |
| Gross Up [(15%)($4,325)] | 649 | 5,225 |
| **Taxable Capital Gains** | | |
| Attribution From Husband (Note Two) | $ 1,144 | |
| Transfer To Jayne (Note Three) | 122 | |
| Lackmere Shares (Note Four) | 394 | |
| Agricultural Land (Note Five) | 9,000 | 10,660 |
| **Other Income And Deductions** | | |
| Spousal Support Payments [($225)(12)] | ($ 2,700) | |
| RRSP Deduction (Note Six) | ( 6,849) | ( 9,549) |
| Net Income For Tax Purposes | | $81,135 |

**Note One** There would be income attribution for the $182 [($3.50)(52)] in dividends received by Mr. Dalton on the shares received as a gift.

**Note Two** In the case of transfers to a spouse, unless an election is made not to have Section 73 apply, the property is transferred at the adjusted cost base of the transferor. There is no recognition of capital gains at the time of transfer. However, when Mr. Dalton sells the shares on August 31, 2019, there would be attribution of taxable capital gains in the amount of $1,144 [($56 - $12)(52)(1/2)].

**Note Three** In the case of a gift to a minor child, it is treated as a deemed disposition at fair market value. This results in a taxable capital gain at the time of transfer in the amount of $122 [($27 - $18)(27)(1/2)].

**Note Four** The taxable capital gain on the Lackmere Ltd. shares would be computed using the average value for the shares. The average value would be calculated as follows:

| | |
|---|---|
| 122 Shares At $92 | $11,224 |
| 178 Shares At $71 | 12,638 |
| Total Cost | $23,862 |
| Average Cost ($23,862 ÷ 300 Shares) | $ 79.54 |

Based on this, the gain would be calculated as follows:

| | |
|---|---|
| Proceeds Of Disposition [(122)($86)] | $10,492 |
| Adjusted Cost Base [(122)($79.54)] | ( 9,704) |
| Capital Gain | $ 788 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain | $ 394 |

**Note Five** When there is a non-arm's length transfer of property for consideration of less than fair market value, ITA 69 deems that, for the transferor, the transfer takes place at fair market value. Given this, the taxable capital gain would be calculated as follows:

| | |
|---|---|
| Deemed Proceeds Of Disposition (FMV) | $28,000 |
| Adjusted Cost Base | ( 10,000) |
| Capital Gain | $18,000 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain | $ 9,000 |

**Note Six** Ms. Worthmore's 2018 Earned Income (assumed to be equal to the 2019 figure) is as follows:

| | |
|---|---|
| Gross Salary - Intra | $73,532 |
| Gross Salary - Lindworth | 2,500 |
| Spousal Support Paid And Deducted [(12)($225)] | ( 2,700) |
| Earned Income | $73,332 |

Ms. Worthmore's maximum deductible 2019 RRSP contribution is calculated as follows:

| | |
|---|---|
| Unused Deduction Room - End of 2018 | Nil |
| Lesser Of: | |
| • 2019 RRSP Dollar Limit = $26,500 | |
| • [(18%)($73,332)] = $13,200 | $13,200 |
| Less 2018 PA | ( 6,351) |
| Maximum Deductible RRSP Contribution | $ 6,849 |

This means the excess contribution of $651 ($7,500 - $6,849) can be carried forward and deducted in future years.

### Part B - Taxable Income

As Ms. Worthmore has no deductions from her Net Income For Tax Purposes, her 2019 Taxable Income would be $81,135, the same amount as her 2019 Net Income For Tax Purposes

### Part C - Tax Payable

**Note Seven** Ms. Worthmore can claim all of the medical expenses of her husband and daughters, Joyce and June without taking into consideration June's income, as she is under 18 years of age. Allowable medical expenses are as follows:

| | |
|---|---|
| John Dalton, Joyce And June Medical Expenses ($1,056 + $2,200 + $9,850) | $13,106 |
| Threshold - Lesser Of: | |
| [(3%)($81,135)] = $2,434 | |
| 2019 Limit Of $2,352 | ( 2,352) |
| Allowable Medical Expenses | $10,754 |

Ms. Worthmore's federal Tax Payable can be calculated as follows:

| | | |
|---|---|---|
| Tax On First $47,630 | | $ 7,145 |
| Tax On Next $33,505 ($81,135 - $47,630) At 20.5 Percent | | 6,869 |
| Gross Federal Tax Payable | | $14,014 |
| Basic Personal Amount | ($12,069) | |
| Spousal $12,069 - $1,065 | ( 11,004) | |
| CPP Contribution | ( 2,749) | |
| EI Premiums | ( 860) | |
| Canada Employment | ( 1,222) | |
| Transfer Of Spouse's Tuition Credit - Lesser of: | | |
| • Absolute Limit Of $5,000 | | |
| • Tuition Paid Of $2,300 | ( 2,300) | |
| Medical Expenses (Note Seven) | ( 10,754) | |
| Credit Base | ($40,958) | |
| Rate | 15% | ( 6,144) |
| Eligible Dividend Tax Credit [(6/11)($69)] | | ( 38) |
| Non-Eligible Dividend Tax Credit [(9/13)($649)] | | ( 449) |
| Charitable Donations (Note Eight) [(15%)($200) + (29%)($342 - $200)] | | ( 71) |
| Political Contributions [(3/4)($100)] | | ( 75) |
| Federal Tax Payable | | $ 7,237 |

**Note Eight** As none of her income is taxed at 33 percent, this rate will not be applicable to the calculation of the charitable donations tax credit.

## Self Study Solution Eleven - 9

### *Taxable Income*

Mr. Slater's Net Income For Tax Purposes And Taxable Income would be calculated as follows:

| | | |
|---|---|---|
| Employment Income - Salary | | $ 35,000 |
| Proprietorship Income ($28,300 - $2,300 - Note One) | | 26,000 |
| Property Income: | | |
| Interest On Savings Account | $ 4,450 | |
| Interest On Loans To Friends | 12,000 | |
| Eligible Canadian Dividends | 44,000 | |
| Gross Up [($44,000)(38%)] | 16,720 | |
| Dividends From U.S. Corporations (Before Withholding, No Gross Up) | 10,000 | 87,170 |
| Taxable Capital Gain [(1/2)($111,500 - $23,000)] | | 44,250 |
| CPP Benefits | | 5,100 |
| Old Age Security Benefits (Note Three) | | 7,400 |
| Restricted Farm Loss (Note Two) | | ( 5,750) |
| Net Income Before OAS Repayment | | $199,170 |
| OAS Repayment (Note Three) - Lesser Of: | | |
| • $7,400 | | |
| • $18,239 [(15%)($199,170 - $77,580)] | | ( 7,400) |
| Net Income For Tax Purposes And Taxable Income | | $191,770 |

**Note One** The drawings from the proprietorship have no effect on the Taxable Income of Mr. Slater. Funds invested are capital and not deductible. The proprietorship income of $28,300 is reduced by the interest of $2,300 on the proprietorship bank loan.

**Note Two** Since Mr. Slater's farming operation is a subordinate source of income, his farm loss would be restricted as follows:

| | |
|---|---|
| Farm Revenues | $36,000 |
| Farm Expenses | ( 45,000) |
| Total Farm Loss | ($ 9,000) |
| Deductible Portion [$2,500 + (1/2)($9,000 - $2,500)] | 5,750 |
| Restricted Farm Loss Carry Over | ($ 3,250) |

The $3,250 restricted farm loss carry over could be carried back to the preceding 3 years and forward for 20 years, to be deducted against farming income.

**Note Three** Even though Mr. Slater did not receive the $7,400, it must be included in income and deducted because he has received an information return which includes the amount.

### *Tax Payable*

Mr. Slater's federal Tax Payable would be calculated as follows:

| | | |
|---|---|---|
| Tax On First $147,667 | | $30,535 |
| Tax On Next $44,103 ($191,770 - $147,667) At 29 Percent | | 12,790 |
| Gross Federal Tax | | $43,325 |
| Tax Credits: | | |
| Basic Personal Amount | ($12,069) | |
| Spousal, Including Extra Amount For Infirmity ($12,069 + $2,230) | ( 14,299) | |
| Mr. Slater's Age {$7,494 - [(15%)($191,770 - $37,790)]} | Nil | |
| Spouse's Disability | ( 8,416) | |
| Canada Employment | ( 1,222) | |
| Credit Base | ($36,006) | |
| Rate | 15% | ( 5,401) |
| Charitable Donations (Note Four) [(15%)($200) + (29%)($2,700 - $200)] | | ( 755) |
| Subtotal = Tax Otherwise Payable For Foreign Tax Credit | | $37,169 |
| Dividend Tax Credit [(6/11)($16,720)] | | ( 9,120) |
| Foreign Tax Credit (Note Five) | | ( 1,500) |
| Federal Political Contributions Tax Credit (Note Six) | | ( 350) |
| OAS Clawback | | 7,400 |
| OAS Withheld | | ( 7,400) |
| Federal Tax Payable | | $26,199 |

**Note Four** As none of his income is taxed at 33 percent, this rate will not be applicable to the calculation of the charitable donations tax credit.

**Note Five** The federal foreign tax credit will be the lesser of the foreign tax actually paid of $1,500 and an amount determined by the following formula:

$$\left[\frac{\text{Foreign Non - Business Income}}{\text{Adjusted Division B Income}}\right][\text{Tax Otherwise Payable}]$$

The Tax Otherwise Payable is equal to federal Tax Payable before the dividend tax credit and political contributions tax credit is deducted (the Subtotal in the preceding table). This amount would be $1,938 [($10,000 ÷ $191,770)($37,169)], leaving the actual taxes of $1,500 as the lesser amount.

**Note Six** The political contributions tax credit can be calculated as follows:

| | |
|---|---|
| 3/4 Of First $400 | $300 |
| 1/2 Of The Next $100 | 50 |
| Total Credit | $350 |

### Other Notes

- The gambling income would not be taxable as Mr. Slater's activity is not extensive enough to be considered a business given his winnings and funds lost in gambling.
- Inheritances are capital receipts and do not constitute Taxable Income.
- The life insurance premiums are not deductible.
- The mortgage payments on his personal residence are not deductible.

## Self Study Solution Eleven - 10

### Deemed Dispositions Immediately Before Death

Immediately before the time of Mrs. Steele's death, there is a deemed disposition of all of her capital property. If the beneficiary is a spouse, the deemed proceeds of disposition will, in general, be equal to the tax cost of the property (ACB or UCC). If Andrea's representatives choose to do so, they can elect out of this rollover and record the transfer at fair market value. For the transfers to her daughter, the deemed proceeds of disposition must be equal to fair market value.

### Principal Residence To Daughter

The bequest of the family home to her daughter would result in a capital gain of $134,600 ($544,000 - $409,400). As it appears to have been Mrs. Steele's principal residence, the application of the principal residence exemption formula to this amount would result in a deduction of the maximum amount of $134,600.

### Other Properties At Death

Under ITA 70(6), property may be transferred at death to a spouse on the basis of adjusted cost base or its UCC. This means that the Rolston Inc. shares, the painting, and the assets of the boutique can be transferred to Mr. Steele with no tax effects in Mrs. Steele's final return. The adjusted cost base and UCC of these properties to Mr. Steele will be the same amounts that applied to Mrs. Steele, prior to her death.

Although the AGF Industries shares would also be eligible for a tax free rollover, it would not be advantageous to do so as there is an unrealized capital loss on these shares. It would be preferable for the legal representative of Mrs. Steele to elect in the final return to have the AGF Industries shares transferred to Mr. Steele at fair market value in order to utilize the capital loss. Electing out of ITA 70(6) is implemented in the final tax return and does not require the filing of a form.

There is no rollover available for the rental property as that is being transferred to her daughter. There is a taxable capital gain for the rental property on both the building and the land and recaptured CCA on the building.

The allowable capital loss resulting from the election on the shares, and the taxable capital gains and recaptured CCA on the deemed disposition of the rental property can be calculated as follows:

| | AGF Shares | Land | Building |
|---|---|---|---|
| Fair Market Value | $ 7,900 | $164,000 | $235,000 |
| Adjusted Cost Base/Capital Cost | ( 10,600) | ( 92,000) | ( 183,000) |
| Capital Gain (Loss) | ($ 2,700) | $ 72,000 | $ 52,000 |
| Inclusion Rate | 1/2 | 1/2 | 1/2 |
| Taxable Capital Gain (Loss) | ($ 1,350) | $ 36,000 | $ 26,000 |

| | Building |
|---|---|
| Capital Cost | $183,000 |
| UCC | ( 144,800) |
| Recapture Of CCA | $ 38,200 |

### *Mortgage Interest - Attribution*

With respect to the mortgage interest received by Mr. Steele, it was earned on mortgages given to him by Mrs. Steele and, as a consequence, it would be attributed to her up until her death on June 3, 2019. This means that $886 [(154/365)($2,100)] of the $2,100 would be included in her income. As attribution from a spouse ceases when the transferor spouse dies, the remaining $1,214 ($2,100 - $886) would be included in Mr. Steele's income. When this is combined with his $425 boutique salary, his total income for the year is $1,639. His income for the whole year, not just prior to Mrs. Steele's death, will decrease the spousal credit available on Mrs. Steele's final return.

### *Net Income For Tax Purposes And Taxable Income*

Mrs. Steele's minimum Taxable Income (ignoring CPP) would be calculated as follows:

| | | |
|---|---|---|
| Business Income | | $55,200 |
| Property Income: | | |
| Eligible Dividends Received | $1,090 | |
| Gross Up [(38%)($1,090)] | 414 | |
| Interest | 2,025 | |
| Attributed Mortgage Interest (Note One) | 886 | |
| Rent Revenues | 41,200 | |
| Rental Expenses (Note Two) | ( 24,650) | |
| Recaptured CCA On Rental Property | 38,200 | 59,165 |
| Net Taxable Capital Gains: | | |
| Taxable Capital Gains On Rental Property ($26,000 + $36,000) | $62,000 | |
| Allowable Capital Loss On AGF Industries Shares | ( 1,350) | 60,650 |
| Net Income | | $175,015 |
| Net Capital Loss Carry Forward (Note Three) | | ( 76,500) |
| Taxable Income | | $ 98,515 |

**Note One** Income attribution would cease with Ms. Steele's death on June 3, 154 days into 2019. Given this, the amount of mortgage interest attribution would be $886 [(2,100)(154/365)].

**Note Two** As there was a deemed disposition of the rental property immediately before the time of Mrs. Steele's death, no CCA can be taken for 2019.

**Note Three** In the year of death, any capital losses and capital loss carry forwards can be deducted against any type of income, not just capital gains, as long as the lifetime capital gains deduction has not been claimed. As a result, although she has net taxable capital gains of only $60,650, she can deduct her total net capital loss carry forward of $76,500.

### *Tax Payable*

Mrs. Steele's minimum federal Tax Payable would be calculated as follows:

| | | |
|---|---|---|
| Tax On First $95,259 | | $16,908 |
| Tax On Remaining $3,256 ($98,515 - $95,259) At 26 Percent | | 847 |
| Gross Federal Tax | | $17,755 |
| Basic Personal Amount | ($12,069) | |
| Spousal ($12,069 - $1,639) | ( 10,430) | |
| Credit Base | ($22,499) | |
| Rate | 15% | ( 3,375) |
| Dividend Tax Credit [(6/11)(38%)($1,090)] | | ( 226) |
| Federal Tax Payable | | $14,154 |

## Self Study Solution Eleven - 11

### *Part A - Taxable Income*

Daniel Tong's employment income would be calculated as follows:

| | | |
|---|---|---|
| Inclusions: | | |
| Salary | $78,000 | |
| 2018 Bonus (Cash Basis) | 6,000 | |
| Home Office Allowance | 2,400 | |
| Standby Charge - No Reduction [($5,200)(2/3)] | 3,467 | |
| Automobile Operating Benefit [(14,000 km)($0.28)] | 3,920 | |
| Group Term Life Insurance Premium | 650 | |
| Dental Insurance | Nil | |
| Stock Option Benefit [(2,500)($15 - $12)] | 7,500 | $101,937 |
| Deductions: | | |
| Company Pension Contributions | ($ 3,900) | |
| Home Office [(30/300)($2,100 + $750)] | ( 285) | |
| Office Supplies | ( 230) | ( 4,415) |
| Net Employment Income | | $ 97,522 |

**Notes**

- In general, the only home office costs that can be deducted are utilities and maintenance. In the case of employees with commission income, a pro rata share of insurance and property taxes would also be deductible. However, it does not appear that Mr. Tong has any commission income.
- As the only capital costs that are deductible by an employee are those related to an automobile, aircraft, or musical instrument, the cost of the computer and peripherals are not deductible.
- The use of employment related frequent flyer points is not considered a taxable benefit by the CRA.

Mr. Tong's Net Income For Tax Purposes and Taxable Income would be calculated as follows:

| | | |
|---|---|---|
| Net Employment Income (See Preceding) | | $ 97,522 |
| Business Income - Sale Of Automobile | | |
| [$14,500 - ($2,500 + $8,100)] | | 3,900 |
| Property Income: | | |
| Portus Dividends Received | $4,500 | |
| Gross Up [(38%)($4,500)] | 1,710 | |
| Less Interest Expense | ( 1,200) | 5,010 |
| Spousal RRSP Withdrawal (Attributed To Mr. Tong) | | 1,000 |
| Net Taxable Capital Gain: | | |
| Taxable Capital Gain On Portus Shares (Note 1) | $3,581 | |
| Allowable Capital Loss On Global Shares (Note 2) | Nil | 3,581 |
| RRSP Contribution (Note 3) | | ( 10,200) |
| Net Income For Tax Purposes | | $100,813 |
| Stock Option Benefit [(1/2)($7,500)] | | ( 3,750) |
| Net Capital Loss Carry Forward (Note 4) | | ( 3,581) |
| Taxable Income | | $ 93,482 |

**Note 1** For shares acquired through the exercise of stock options, the adjusted cost base is the fair market value of the shares at the time of exercise. Based on this, the average cost of his Portus Ltd. shares is calculated as follows:

| | |
|---|---|
| 2,500 Shares At $15 | $37,500 |
| 250 Shares At $18 | 4,500 |
| Total Adjusted Cost Base | $42,000 |

Based on this total, the average cost per share is $15.27 ($42,000 ÷ 2,750). Using this figure, the taxable capital gain would be calculated as follows:

| | |
|---|---|
| Proceeds [(1,250)($21)] | $26,250 |
| Adjusted Cost Base [(1,250)($15.27)] | ( 19,088) |
| Capital Gain | $ 7,162 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain | $ 3,581 |

**Note 2** The $2,400 loss ($8,600 - $11,000) is deemed to be superficial, as Mr. Tong repurchased more than 800 Global shares within 30 days of the original disposition. This means that the loss will be disallowed. However, it will be added to the adjusted cost base of the replacement shares, giving a total adjusted cost base of $8,200 ($5,800 + $2,400).

**Note 3** Mr. Tong's 2019 RRSP deduction room would be calculated as follows:

| | |
|---|---|
| Lesser Of: | |
| 2019 RRSP Limit = $26,500 | |
| 18% Of $61,500 = $11,070 | $11,070 |
| 2018 Pension Adjustment | Nil |
| Total 2019 Deduction Room | $11,070 |

While he has $11,070 in deduction room, his actual deduction is limited to $10,200, his $2,200 in undeducted contributions from the beginning of the year, plus his $8,000 contribution to his wife's RRSP.

**Note 4** Mr. Tong has a net capital loss balance of $11,500 ($2,500 + $6,000 + $3,000). However, the amount that can be deducted is limited to the 2019 taxable capital gain, or $3,581. This will leave a net capital loss balance of $7,919 ($11,500 - $3,581).

### *Part B - Tax Payable*

Mr. Tong's minimum federal Tax Payable is calculated as follows:

| | | |
|---|---|---|
| Tax On First $47,630 | | $7,145 |
| Tax On Next $45,852 ($93,482 - $47,630) At 20.5 Percent | | 9,400 |
| Gross Federal Tax | | $16,545 |
| Basic Personal Amount | ($12,069) | |
| Spousal | ( 12,069) | |
| CPP | ( 2,749) | |
| EI | ( 860) | |
| Canada Employment | ( 1,222) | |
| Transfer Of Tuition (Note 5) | ( 5,000) | |
| Credit Base | ($33,969) | |
| Rate | 15% | ( 5,095) |
| Dividend Tax Credit [(6/11)(38%)($4,500)] | | ( 933) |
| Federal Tax Payable | | $10,517 |

**Note 5** Marion's federal Tax Payable is nil as the scholarship is not taxable income.

| | |
|---|---|
| Interest Income | $ 3,000 |
| Scholarship ($10,000 - $10,000) | Nil |
| Taxable Income | $ 3,000 |
| Basic Personal Amount | ( 12,069) |
| Federal Tax Payable | Nil |

As Marion is unable to use any of her tuition credit, the transfer is the lesser of:

- The absolute limit of $5,000
- The actual tuition cost of $7,150

Given this, the maximum transfer is $5,000. However, the $2,150 ($7,150 - $5,000) excess can be carried forward indefinitely to be used against Marion's future Tax Payable.

### *Part B - Carry Forwards*

- From Note 4, there is a net capital loss of $7,919 available for carry forward to subsequent years.
- From Note 5, Marion has a $2,150 tuition amount available for carry forward to subsequent years.

## Solution to Tax Software Self Study Problem - Chapter 11

The complete tax return is available on the MyLab in two versions, a T1 ProFile return file and a .PDF file. Note that prior to late January, 2020, the returns will be for 2018, not 2019 as the 2019 filing version will not yet be available.

For more information on how to use the ProFile tax program, refer to the Chapter 4 sample tax return in this Study Guide.

### *Notes To Tax Return*

- Diane transfers the $5,000 maximum tuition amount to Eleanor and carries forward the remaining $2,000 [$7,000 - $5,000]. The carry forward can only be used by Diane.
- Eleanor cannot claim the charitable donation made by Diane, but Diane can carry it forward for up to 5 years.
- Since Amy is under 18 and wholly dependent, Eleanor claimed the eligible dependant credit for Amy.
- Note that, because Marjorie is not infirm, Eleanor can claim no credit for her.
- Since Diane and Marjorie are over 17 years of age, their medical expenses are reduced by 3 percent of their Net Income For Tax Purposes. This means that none of Marjorie's medical expenses can be claimed by Eleanor.
- In calculating work space in the home costs, the household insurance is not deductible as the T4 information shows she has no commission income. The car insurance is not relevant as there is no information that Eleanor uses her car for employment related purposes.
- The Croft Computer Camp was an overnight camp which means that the deductible costs are limited to $125 per week, a total of $250 [(2)($125)]. In contrast, there is no limit on the costs of day camps. This provides for the deduction of the entire $400 cost of the Y Day Camp.
- Since Eleanor is currently renting out her house, but plans to move back into it, no CCA is taken on the Class 1 building to preserve her principal residence status. Since she had a rental loss in the previous year, and the cost is equal to the UCC, no CCA has been taken on the building. Her CCA on the Class 8 assets would not affect her principal residence election and should be taken. The payments on principal are not deductible.

  If she chose to take CCA on the building, the maximum potential CCA for the year would be $6,756 [(4%)($168,900)] since the first year one-half rule does not apply to the second year of rental. The maximum deductible CCA on the building would be limited to the net rental income after the CCA on the Class 8 assets of $5,553 ($5,887 - $334). This would reduce her Tax Payable for 2018, but she would no longer be eligible for the principal residence gain reduction on the property. In addition, the CCA would be recaptured on a subsequent sale if the proceeds were greater than the UCC.

  Given her inheritance, she should have more than sufficient funds to pay her income taxes without taking CCA on her rental property. As a result, she should preserve her ability to claim the principal residence gain reduction by not taking CCA on the house.

### *Tax Planning Points*

- Since Marjorie is taking care of Amy and is over 18 years old, Eleanor could pay her for child care costs and deduct them. Given Marjorie's low income, it is probable that Eleanor is already providing some funds to her. The amount should be calculated on a basis that is no more than the going rate per hour for similar services for the time when Amy is home and Eleanor is not. As long as Marjorie's income remains below the basic personal credit plus the age credit, it would not result in any income tax liability for Marjorie. Since she is over 80 years old, there would be no CPP liability.
- Although she is not required to file, Marjorie should file a tax return, otherwise she will not be eligible for the GST credit. If Eleanor pays her for child care in the future, filing a tax return could also reduce the probability that Eleanor will be asked for proof of payment.
- Although she is not required to file, Diane should file a tax return, otherwise she will not be eligible for the GST credit and she will not benefit from the RRSP deduction room created during the year. Filing a tax return will also make her tuition tax credit and charitable donation tax credit easier to keep track of for carry forward purposes.
- With the inflow of funds from the inheritance, Eleanor should review her debt outstanding and pay off any balances that have non-deductible interest, such as credit card balances. Although it is not exactly a tax planning point, Eleanor should compare the after tax cost of the interest she is paying on her rental property mortgage with the after tax yields that she can obtain on her investments to determine whether she should pay off her mortgage.

### *Part B*

The maximum deductible RRSP contribution that Eleanor can make for 2019 is calculated as $5,538 by the program on the form "RRSPLimit". To access the form, press <F4> and type "rrsplimit" in the form box.

Note that if Eleanor chooses to deduct CCA on her rental building and reduce her net rental income to nil, her maximum deductible RRSP contribution will be reduced by $1,000 [(18%)($5,553)]. This is another reason she should not take CCA on the rental building.

Given her inheritance, Eleanor should contribute the maximum deductible RRSP contribution as early in 2019 as possible.

Eleanor should open an RESP for Amy if she has not already done so. How much she should contribute will depend on many factors (see the text), but she should request that her accountant create a contribution schedule that will maximize Canada Education Savings Plan contributions and optimize RESP contributions.

Eleanor should open TFSAs for herself, Diane and possibly Marjorie and determine how much she should contribute to each. This would involve many investment and budgeting factors, as well as her future financial plans. Since the contributions are not deductible and the withdrawals are not taxable, the TFSAs will not have an effect on any of the tax returns.

Given her inheritance she should also consider overcontributing up to $2,000 to her RRSP which would allow her to take advantage of the tax free earnings in the RRSP without penalty. This would only be advantageous as long as she plans to have earned income for RRSP purposes sufficient to deduct the $2,000 in the future.

## Chapter 11 Learning Objectives

After completing Chapter 11, you should be able to:

1. Recall the specified deductions from Net Income For Tax Purposes in the calculation of Taxable Income (paragraph [P hereafter] 11-1 to 11-7).
2. Apply the rules related to lump-sum payments (P 11-8 to 11-13).
3. Recall the general rules for the treatment of losses and loss carry overs (P 11-14 to 11-29).
4. Explain the treatment of losses on personal use property (P 11-30).
5. Apply the loss carry over provisions applicable to losses on listed personal property (P 11-31 to 11-35).

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6. Apply the loss carry over provisions applicable to non-capital losses (P 11-36 to 11-40).
7. Apply the loss carry over provisions applicable to net capital losses (P 11-41 to 11-44).
8. Apply the rules for the conversion of a net capital loss carry over to a non-capital loss carry over (P 11-45 to 11-49).
9. Explain the special rules for net capital losses that are applicable to deceased taxpayers (P 11-50 to 11-54).
10. Explain the special features associated with Allowable Business Investment Losses (P 11-55 to 11-62).

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11. Apply the loss carry over provisions applicable to regular and restricted farm losses (P 11-63 to 11-67).
12. Apply the provisions of the lifetime capital gains deduction (P 11-68 to 11-97).
13. Describe the importance of the ordering of deductions and losses in computing Net Income For Tax Purposes and Taxable Income (P 11-98 to 11-103).
14. Describe Basic Federal Tax Payable (P 11-104 to 11-109).
15. Identify amounts that may be taxed as split income (P 11-110 to 11-124).

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16. Determine the applicability of the Tax On Split Income (TOSI) (P 11-125 to 11-131).
17. Describe those items that will be Excluded Amounts with respect to the TOSI (P 11-132 to 11-142).
18 Calculate the amount of the TOSI (P 11-143 to 11-147).
19. Apply the provisions for the transfer of dividends to a spouse or common-law partner (P 11-148).
20. Calculate the charitable donations tax credit for donations of various types of property (P 11-149 to 11-174).

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21. Calculate foreign business and non-business income tax credits (P 11-175 to 11-186).
22. Apply the provisions associated with the alternative minimum tax (P 11-187 to 11-200).
23. Review a personal tax return completed using the ProFile T1 tax preparation software program.

# CHAPTER 12

## How To Work Through Chapter 12

We recommend the following approach in dealing with the material in this Chapter:

**Note On Recent Developments**

- Read the Note at the beginning of the Chapter (in the textbook).

**Computation Of Net Income For Corporations**

- Read paragraph 12-1 to 12-4.
- Do Exercise Twelve-1 (in the textbook) and check the solution in this Study Guide.
- Do Self Study Problem Twelve-1 which is available on MyLab and check the solution in this Study Guide.

**Deductions Available For Corporations In The Computation Of Taxable Income**

- Read paragraph 12-5 to 12-9.

**Dividends Received From Other Corporations**

- Read paragraph 12-10 to 12-12.
- Do Exercise Twelve-2 and check the solution in this Study Guide.

**Dividends Received - Other Situations Including Stop Loss Rules**

- Read paragraph 12-13 to 12-22.
- Do Exercise Twelve-3 and check the solution in this Study Guide.
- Read paragraph 12-23.
- Do Self Study Problem Twelve-2 and check the solution in this Study Guide.

**Non-Capital Loss Carry Over For A Corporation**

- Read paragraph 12-24 to 12-30.
- Do Exercises Twelve-4 and Twelve-5 and check the solutions in this Study Guide.

**Ordering Of Taxable Income Deductions**

- Read paragraph 12-31 to 12-36.
- Do Self Study Problems Twelve-3 and Twelve-4 and check the solutions in this Study Guide.

**Geographical Allocation Of Income To Permanent Establishments**

- Read paragraph 12-37 to 12-44.
- Do Self Study Problem Twelve-5 and check the solution in this Study Guide.

**Federal Tax Payable For Corporations**

- Read paragraph 12-45 to 12-51.
- Do Exercise Twelve-6 and check the solution in this Study Guide.

**Provincial Tax Payable For Corporations**

- Read paragraph 12-52 to 12-62.

**Other Goals Of The Corporate Tax System**

- Read paragraph 12-63 to 12-64.

**Small Business Deduction - Definitions And Calculation**

- Read paragraph 12-65 to 12-101.
- Do Exercise Twelve-7 and check the solution in this Study Guide.

**Elimination Of The Small Business Deduction For Large CCPCs**

- Read paragraph 12-102 to 12-113.
- Do Exercise Twelve-8 and check the solution in this Study Guide.
- Read paragraph 12-114 to 12-117.
- Do Exercise Twelve-9 and check the solution in this Study Guide.
- Read paragraph 12-118 to 12-120.
- Do Exercise Twelve-10 and check the solution in this Study Guide.

**Personal Services Corporations, Professional Corporations And Management Companies**

- Read paragraph 12-121 to 12-129.

**Manufacturing And Processing Profits Deduction**

- Read paragraph 12-130 to 12-146.
- Do Exercise Twelve-11 and check the solution in this Study Guide.

**General Rate Reduction**

- Read paragraph 12-147 to 12-154.
- Do Exercise Twelve-12 and check the solution in this Study Guide.
- Read paragraph 12-155 to 12-160.
- Do Exercise Twelve-13 and check the solution in this Study Guide.
- Do Self Study Problems Twelve-6 to Twelve-9 and check the solutions in this Study Guide.

**Foreign Income Tax Credits For Corporations**

- Read paragraph 12-161 to 12-173.
- Do Exercise Twelve-14 and check the solution in this Study Guide.
- Do Self Study Problem Twelve-10 and check the solution in this Study Guide.

**Refundable Journalism Labour Tax Credit**

- Read paragraph 12-174 to 12-177.

**To Complete This Chapter**

- If you would like more practice in problem solving, do the Supplementary Self Study Problems for the chapter. These problems and solutions are available on MyLab.
- Review the Key Terms Used In This Chapter in the textbook at the end of Chapter 12. Consult the Glossary for the meaning of any key terms you do not know.
- Test yourself with the Chapter 12 Glossary Flashcards available on MyLab.
- Ensure you have achieved the Chapter 12 Learning Objectives listed in this Study Guide.
- As a review, we recommend you view the PowerPoint presentation for Chapter 12 that is on MyLab.

**Practice Examination**

- Write the Practice Examination for Chapter 12 that is on MyLab. Mark your examination using the Practice Examination Solution that is on MyLab.

## Solutions to Chapter Twelve Exercises

### *Exercise Twelve - 1 Solution*

**Item 1** You would add the accounting loss of $5,600 ($48,300 - $53,900). You would also add the recapture of CCA of $13,700 ($34,600 - $48,300), for a total addition of $19,300.

**Item 2** As goodwill is not amortized for accounting purposes and there was no impairment during the year, no adjustment of the accounting figures is required. However, when the goodwill is added to Class 14.1, it would be subject to the half-year rule and amortization at a rate of 5 percent per year. This means that you would subtract of CCA $4,500 [($180,000)(1/2)(5%)].

**Item 3** You would add the charitable donations of $15,000.

**Item 4** You would deduct the premium amortization of $4,500.

### *Exercise Twelve - 2 Solution*

| | |
|---|---|
| Net Income For Tax Purposes | $263,000 |
| Dividends Received | ( 14,200) |
| Charitable Donations | ( 8,600) |
| Non-Capital Loss Carry Forward (All) | ( 82,000) |
| Net Capital Loss Carry Forward* | ( 14,250) |
| Taxable Income | $143,950 |

*While there is a net capital loss of $18,000 available, the actual deduction is limited to the current year's taxable capital gains of $14,250. The remaining net capital loss carry forward is $3,750 ($18,000 - $14,250).

### *Exercise Twelve - 3 Solution*

Although Loren has held the shares for more than 365 days, it owns more than 5 percent of the shares. As a result, this transaction would be subject to the stop loss rules. The deductible loss would be calculated as follows:

| | |
|---|---|
| Proceeds Of Disposition [($21.15)(1,000)] | $21,150 |
| Adjusted Cost Base [($25.30)(1,000)] | ( 25,300) |
| Total Loss | ($ 4,150) |
| Disallowed Portion [($2.16)(1,000)] | 2,160 |
| Capital Loss | ($ 1,990) |
| Inclusion Rate | 1/2 |
| Allowable Capital Loss | ($ 995) |

### *Exercise Twelve - 4 Solution*

Hacker's Net Income For Tax Purposes would be nil, the business and property income of $63,500, less the allowable business investment loss of $75,750 [(1/2)($151,500)].

The net capital loss carry over balance at the end of the year would be $7,650 [(1/2)($23,100 - $38,400)].

The non-capital loss carry over would be calculated as follows:

| | |
|---|---|
| Amount E (The ABIL) | $75,750 |
| Amount F - ITA 3(c) Income | ( 63,500) |
| Non-Capital Loss At End Of Year | $12,250 |

### Exercise Twelve - 5 Solution

The non-capital loss balance at the end of the year would be calculated as follows:

| | | |
|---|---|---|
| Amount E: | | |
| Net Business Loss | | $273,000 |
| ABIL | | 5,250 |
| Dividends Received And Deducted | | 48,000 |
| Net Capital Loss Carry Forward Deducted (Limited To Net Taxable Capital Gains For The Year) | | 13,500 |
| Total For Amount E | | $339,750 |
| Amount F - ITA 3(c) Income: | | |
| Interest | ($27,200) | |
| Dividends | ( 48,000) | |
| Net Taxable Capital Gains [(1/2)($111,000 - $84,000)] | ( 13,500) | ( 88,700) |
| Non-Capital Loss At End Of Year | | $251,050 |
| Net Capital Loss Carry Forward ($19,000 - $13,500) | | $ 5,500 |

### Exercise Twelve - 6 Solution

The percentage of Taxable Income earned in each province would be calculated as follows:

| | Gross Revenues | | Wages And Salaries | |
|---|---|---|---|---|
| | Amount | Percent | Amount | Percent |
| Ontario | $1,303,000 | 44.6% | $ 52,000 | 31.5% |
| Manitoba | 896,000 | 30.7% | 94,000 | 57.0% |
| Not Related To A Province | 724,000 | 24.7% | 19,000 | 11.5% |
| Total | $2,923,000 | 100.0% | $165,000 | 100.0% |

The average of the two percentages applicable for income not related to a province is 18.1%, leaving an average for income related to a province of 81.9%. Given this, federal Tax Payable can be calculated as follows:

| | |
|---|---|
| Base Amount Of Part I Tax [(38%)($226,000)] | $85,880 |
| Federal Tax Abatement [(10%)(81.9%)($226,000)] | ( 18,509) |
| General Rate Reduction [(13%)($226,000)] | ( 29,380) |
| Federal Tax Payable | $37,991 |

### Exercise Twelve - 7 Solution

As a CCPC throughout the year and with no associated companies, Kartoom is eligible for the full amount of the $500,000 annual business limit. The amount eligible for the small business deduction will be the least of:

| | |
|---|---|
| **Active Business Income** | **$425,000** |
| **Adjusted Taxable Income** (See following calculation) | **$292,857** |
| **Annual Business Limit** | **$500,000** |

| | |
|---|---|
| Net Income For Tax Purposes | $570,000 |
| Dividends Received | ( 85,000) |
| Non-Capital Loss Carry Forward | ( 160,000) |
| Taxable Income | $325,000 |
| 100/28 Times Foreign Non-Business Tax Credit [(100/28)(15%)($60,000)] | ( 32,143) |
| Adjusted Taxable Income | $292,857 |

The least of these figures is the adjusted Taxable Income of $292,857.

### *Exercise Twelve - 8 Solution*

The B component of the ITA 125(5.1) reduction formula is $2,925 [(.00225)($11,300,000 - $10,000,000)]. Given this, the required reduction would be calculated as follows:

[($500,000)($2,925 ÷ $11,250)] = $130,000 **Reduction**

This reduction leaves the annual business limit at $370,000 ($500,000 - $130,000).

The foreign non-business income tax credit is equal to $5,400 [(15%)($36,000)]. The small business deduction for Largely Small Inc. is equal to 19 percent of the least of:

| | | |
|---|---|---|
| • Active Business Income ($1,233,000 - $36,000) | | $1,197,000 |
| • Taxable Income ($1,233,000 - $914,000) | $319,000 | |
| Less 100/28 Times Non-Business Income FTC Of $5,400 | ( 19,286) | $ 299,714 |
| • Reduced Annual Business Limit ($500,000 - $130,000) | | $ 370,000 |

The small business deduction is equal to $56,946 [(19%)($299,714)]. The foreign non-business income is less than $50,000 so the calculation of the passive income grind is not required.

### *Exercise Twelve - 9 Solution*

The required reduction in the annual business limit would be calculated as follows:

[($300,000/$500,000)][(5)($105,000 - $50,000)] = $165,000 **Reduction**

This reduction would leave the company's annual business limit at $135,000 ($300,000 - $165,000).

The 2019 small business deduction for Investco would be 19 percent of the least of:

| | |
|---|---|
| • Active Business Income | $350,000 |
| • Taxable Income | $475,000 |
| • Reduced Annual Business Limit | $135,000 |

The small business deduction is equal to $25,650 [(19%)($135,000)].

### Exercise Twelve - 10 Solution

**Case 1** The B component of the TCEC reduction formula is $7,875 [(.00225)($13,500,000 - $10,000,000)]. Given this, the required reduction would be calculated as follows:

[($350,000)($7,875 ÷ $11,250)] = $245,000 **Reduction**

The calculation of the AAII grind would be calculated as follows:

[($350,000/$500,000)][(5)($72,000 - $50,000)] = $77,000 **Reduction**

The greater of these reductions is the TCEC grind amount of $245,000. This leaves an annual business limit of $105,000 ($350,000 - $245,000). Using this, the 2019 small business deduction for Reduco would be 19 percent of the least of:

| | |
|---|---|
| • Active Business Income | $450,000 |
| • Taxable Income ($540,000 - $60,000) | $480,000 |
| • Reduced Annual Business Limit | $105,000 |

The small business deduction in this Case 1 is equal to $19,950 [(19%)($105,000)].

**Case 2** The B component of the TCEC reduction formula is $2,250 [(.00225)($11,000,000 - $10,000,000)]. Given this, the required reduction would be calculated as follows:

[($350,000)($2,250 ÷ $11,250)] = $70,000 **Reduction**

The AAII reduction would be the same $77,000 that was determined in Case 1. This would also be the greater of the two reductions, resulting in an annual business limit of $273,000 ($350,000 - $77,000). Given this, the small business deduction for Reduco is equal to 19 percent of the least of:

| | |
|---|---|
| • Active Business Income | $450,000 |
| • Taxable Income ($540,000 - $60,000) | $480,000 |
| • Reduced Annual Business Limit | $273,000 |

The small business deduction in this Case 2 is equal to $51,870 [(19%)($273,000)].

### Exercise Twelve - 11 Solution

The small business deduction for Marion Manufacturing would be equal to 19 percent of the least of:

| | | |
|---|---|---|
| • Canadian Active Business Income (M&P Profits) | | $411,000 |
| • Taxable Income ($462,000 - $310,000) | $152,000 | |
| Less 4 Times Business Income FTC Of $3,150 | ( 12,600) | $139,400 |
| • Annual Business Limit | | $500,000 |

Based on this, the small business deduction would be $26,486 [(19%)($139,400)].

The M&P deduction would be equal to 13 percent of the lesser of:

| | | |
|---|---|---|
| • M&P Profits | $411,000 | |
| Less Amount Eligible For Small Business Deduction | ( 139,400) | $271,600 |
| • Taxable Income ($462,000 - $310,000) | $152,000 | |
| Less: | | |
| Amount Eligible For Small Business Deduction | ( 139,400) | |
| 4 Times Business FTC Of $3,150 | ( 12,600) | |
| Aggregate Investment Income (Taxable Capital Gain) | ( 30,000) | $ Nil |

The M&P profits deduction would be equal to nil.

It would have been possible to increase the small business deduction to the full $411,000 of active business income by increasing Taxable Income to $423,600 ($411,000 + $12,600 FTC adjustment that will be deducted). This could be accomplished by limiting the deduction for charitable donations to $38,400 ($462,000 - $423,600). The remaining unclaimed donations of $271,600 ($310,000 - $38,400) could be carried forward for up to five years.

Although this increases Taxable Income and the total Tax Payable for the year, there could still be an ultimate tax savings with this approach, as the small business deduction cannot be carried forward, while charitable donations can be. As the Exercise states that Marion expects large increases in income in the future, this approach would be advantageous if Marion's expectations turn out to be correct.

### *Exercise Twelve - 12 Solution*

The federal Tax Payable for Marchand Inc. would be calculated as follows:

| | |
|---|---|
| Base Amount Of Part I Tax [(38%)($320,000)] | $121,600 |
| Federal Tax Abatement [(10%)($320,000)] | ( 32,000) |
| M&P Deduction [(13%)($180,000)] | ( 23,400) |
| General Rate Reduction [(13%)($320,000 - $180,000)] | ( 18,200) |
| Federal Tax Payable | $ 48,000 |

As you would expect, the overall tax rate is equal to 15 percent ($48,000 ÷ $320,000).

### *Exercise Twelve - 13 Solution*

The federal Tax Payable for Redux Ltd. would be calculated as follows:

| | |
|---|---|
| Base Amount Of Part I Tax [(38%)($200,000)] | $76,000 |
| Federal Tax Abatement [(10%)($200,000)] | ( 20,000) |
| Small Business Deduction (Note One) | ( 26,600) |
| M&P Deduction (Note Two) | ( 650) |
| General Rate Reduction (Note Three) | ( 7,150) |
| Federal Tax Payable | $21,600 |

**Note One** The small business deduction would be equal to $26,600, 19 percent of $140,000, the least of:

| | |
|---|---|
| Active Business Income | 200,000 |
| Taxable Income | 200,000 |
| Business Limit | 140,000 |

**Note Two** The M&P deduction would be equal to $650, 13 percent of $5,000, the lesser of:

| | | |
|---|---|---|
| • M&P Profits | $145,000 | |
| Amount Eligible For Small Business Deduction | ( 140,000) | $ 5,000 |
| • Taxable Income | $200,000 | |
| Amount Eligible For Small Business Deduction | ( 140,000) | $60,000 |

**Note Three** The general rate reduction would be calculated as follows:

| | |
|---|---|
| Taxable Income | $200,000 |
| Amount Eligible For The SBD | ( 140,000) |
| Amount Eligible For The M&P Deduction | ( 5,000) |
| Full Rate Taxable Income | $ 55,000 |
| Rate | 13% |
| General Rate Reduction | $ 7,150 |

### *Exercise Twelve - 14 Solution*

The Taxable Income figure would be calculated as follows:

| | |
|---|---|
| Net Income For Tax Purposes | $146,000 |
| Dividends Received | ( 30,000) |
| Non-Capital Loss Carry Forward | ( 75,000) |
| Net Capital Loss Carry Forward | ( 25,000) |
| Taxable Income | $ 16,000 |

Starting with this figure, the required calculation of Part I Tax Payable would be as follows:

| | |
|---|---|
| Base Amount Of Part I Tax [(38%)($16,000)] | $6,080 |
| Federal Tax Abatement [(88%)(10%)($16,000)] | ( 1,408) |
| General Rate Reduction [(13%)($16,000)] | ( 2,080) |
| Foreign Business Income Tax Credit (See Note) | ( 879) |
| Part I Tax Payable | $1,713 |

**Note** The foreign business income tax credit would be $879, the least of:

- The amount withheld $3,000
- $\left[\frac{\$20{,}000}{\$146{,}000 - \$30{,}000 - \$25{,}000}\right][\$6{,}080 - \$2{,}080]$ $879
- $6,080 - $2,080 $4,000

The unused foreign business tax amount of $2,121 ($3,000 - $879) can be carried back 3 years and forward for 10 years. In calculating the allowable tax credit for such carry overs, these unused amounts will be added to the foreign tax paid factor in the calculation of the foreign business income tax credit.

## Self Study Solution Twelve - 1

1. The required adjustments would be:
   - Add: Amortization expense of $254,000.
   - Deduct: CCA of $223,000.

2. The required adjustment would be:
   - Deduct: Premium amortization of $2,000.

3. The capital gain on this sale is $40,000 ($120,000 - $80,000). Because $48,000 ($120,000 - $72,000) of the proceeds are outstanding at the end of the current year, a reserve can be deducted. The reserve will be the lesser of:
   - $16,000 [($40,000)($48,000 ÷ $120,000)]
   - $32,000 [($40,000)(20%)(4 - 0)]

   The deduction of the lesser value of $16,000 will leave a capital gain of $24,000 ($40,000 - $16,000). Based on this, the required adjustments are:
   - Deduct: Accounting gain of $67,000 ($120,000 - $53,000).
   - Add: Taxable capital gain of $12,000 [(1/2)($24,000)].

   There is no recapture on this disposition as the Company still owns Class 44 assets, and there is a positive balance in the class at the end of the year.

4. The required adjustments would be:
   - Add: Membership fees of $8,000.
   - Add: Non-deductible entertainment expenses of $6,000 [(50%)($12,000)].

5. The required adjustment would be:
   - Add: Charitable donations of $11,000.

6. The required adjustments would be:
   - Add: Accounting loss of $16,000 ($23,000 - $39,000).
   - Add: Recapture of $23,000 (Nil - $23,000).

## Self Study Solution Twelve - 2

1. The adjustments here would be as follows:

- Add the donation of $45,000.
- Deduct the accounting gain of $7,000 ($45,000 - $38,000).
- Add the taxable capital gain of $1,500 [(1/2)($45,000 - $42,000)].
- Add the recapture of $5,500 ($42,000 - $36,500).

2. The adjustments here would be as follows:

- Add the amortization expense of $32,450.
- Deduct the CCA of $27,650.

3. The adjustment here would be as follows:

- Add the increase in the warranty liability of $2,010 ($10,470 - $8,460).

4. Since item 1 created a taxable capital gain of $1,500, the adjustments here would be as follows:

- Add the accounting loss of $550 ($12,870 - $12,320).
- Deduct the allowable capital loss of $275 [(1/2)($12,870 - $12,320)].

5. The adjustment here would be as follows:

- Add the $2,600 in bond discount amortization.

6. The adjustments here would be as follows:

- Add the accounting loss of $14,810 ($107,000 - $92,190).
- Deduct the terminal loss of $9,580 ($92,190 - $101,770).

## Self Study Solution Twelve - 3

The required calculation of Net Income For Tax Purposes and Taxable Income is as follows:

| | | |
|---|---|---|
| ITA 3(a) Dividends | | $ 22,300 |
| ITA 3(b) Taxable Capital Gains | $15,600 | |
| Allowable Capital Losses | ( 3,450) | 12,150 |
| ITA 3(c) | | $ 34,450 |
| ITA 3(d) Business Loss | | ( 126,000) |
| Net Income For Tax Purposes | | Nil |
| Dividends Received | | ($ 22,300) |
| Net Capital Loss Carry Forward | | |
| (Limited To Net Taxable Capital Gains) | | ( 12,150) |
| Charitable Donations | | Nil |
| Taxable Income | | Nil |

The carry forward balances available at the end of the year are as follows:

**Net Capital Loss Carry Forward**

| | |
|---|---|
| Beginning Balance | $42,300 |
| Used During Year | ( 12,150) |
| Net Capital Loss Carry Forward | $30,150 |

**Charitable Donations Carry Forward**

| | |
|---|---|
| Beginning Balance | $3,500 |
| Added During Year | 2,600 |
| Used During Year | Nil |
| Unused Charitable Donations | $6,100 |

**Non-Capital Loss**

| | |
|---|---|
| Balance Under E | |
| Dividends | $ 22,300 |
| Business Loss | 126,000 |
| Net Capital Loss Carry Forward Deducted | 12,150 |
| Subtotal | $160,450 |
| Balance Under F - Income Under ITA 3(c) | ( 34,450) |
| Non-Capital Loss | $126,000 |

**Non-Capital Loss Carry Forward**

| | |
|---|---|
| Balance From Previous Years | $ 33,500 |
| Added During Year | 126,000 |
| Used During Year | Nil |
| Non-Capital Loss Carry Forward | $159,500 |

As per the policy of the Company, this solution minimizes the net capital loss carry forward. In the absence of this policy, an alternative solution could minimize the non-capital loss balance.

# Self Study Solution Twelve - 4

## 2016 Analysis

### *Net And Taxable Income*

The required calculations for Net Income For Tax Purposes and Taxable Income are as follows:

| | |
|---|---|
| Net Business Income | $123,000 |
| Dividends | 6,000 |
| **Net Income For Tax Purposes** | **$129,000** |
| Dividends | ( 6,000) |
| Charitable Donations | ( 1,500) |
| **Taxable Income** | **$121,500** |

There is an allowable capital loss of $6,000 [(1/2)($12,000)] that can only be deducted against taxable capital gains.

### *2016 Carry Forwards*

The following carry forward amount is available at the end of 2016:

- Net Capital Loss $6,000

## 2017 Analysis

### *Net And Taxable Income*

The required calculations for Net Income For Tax Purposes and Taxable Income are as follows:

| | |
|---|---|
| Net Business Income | $18,000 |
| Taxable Capital Gain [(1/2)($32,000)] | 16,000 |
| Dividends | 7,000 |
| **Net Income For Tax Purposes** | **$41,000** |
| Dividends | ( 7,000) |
| Charitable Donations | ( 8,500) |
| Net Capital Loss Carry Forward (All) | ( 6,000) |
| **Taxable Income** | **$19,500** |

### *2017 Carry Forwards*

As the Company was able to deduct all of the net capital loss from 2016, no carry forward amounts remain.

## 2018 Analysis

### *Net And Taxable Income*

The required calculations for Net Income For Tax Purposes and Taxable Income are as follows:

| | |
|---|---|
| Dividends = Income Under ITA 3(c) | $ 6,000 |
| Business Loss [ITA 3(d)] | ( 85,000) |
| **Net Income For Tax Purposes And Taxable Income** | Nil |

### Net Capital Loss Carry Back And Amended 2017 Return

In 2018, there is a net capital loss of $12,500 [(1/2)($25,000)]. While there was a $16,000 taxable capital gain in 2017, $6,000 of this amount was used by the net capital loss carry forward from 2016. This means that only $10,000 of the $12,500 can be carried back to 2017. Given this, the 2017 amended return would be as follows:

| | |
|---|---|
| Taxable Income As Reported | $19,500 |
| Net Capital Loss Carry Back From 2018 | ( 10,000) |
| Amended 2017 Taxable Income | $ 9,500 |

### Non-Capital Loss Carry Back And Amended 2016 Return

The 2018 non-capital loss would be calculated as follows:

| | |
|---|---|
| Business Loss | $85,000 |
| Dividends Received And Deducted | 6,000 |
| Amount E | $91,000 |
| Income Under ITA 3(c) | ( 6,000) |
| 2018 Non-Capital Loss | $85,000 |

As the 2016 Taxable Income was $121,500, all of this loss can be carried back to that year. Given this, the amended return for 2016 would be as follows:

| | |
|---|---|
| Taxable Income As Reported In 2016 | $121,500 |
| Non-Capital Loss Carry Back from 2018 | ( 85,000) |
| Amended 2016 Taxable Income | $ 36,500 |

### 2018 Carry Forwards

The following carry forward amounts are available at the end of 2018:

| | |
|---|---|
| • Net Capital Loss ($12,500 - $10,000) | $2,500 |
| • Charitable Donations | 4,200 |
| • Non-Capital Loss | Nil |

## 2019 Analysis

### Net And Taxable Income

The required calculations for Net Income For Tax Purposes and Taxable Income are as follows:

| | |
|---|---|
| Net Business Income | $32,000 |
| Taxable Capital Gains | 8,000 |
| Dividends | 9,000 |
| **Net Income For Tax Purposes** | **$49,000** |
| Dividends | ( 9,000) |
| Current Charitable Donations | ( 1,800) |
| Charitable Donations Carry Forward | ( 4,200) |
| Net Capital Loss Carry Forward (All) | ( 2,500) |
| **Taxable Income** | **$31,500** |

### 2019 Carry Forwards

At the end of 2019, there are no carry forward balances.

## Self Study Solution Twelve - 5

The allocation to each of these provinces and the United States would be based on the following calculations:

| | Salaries And Wages | | Gross Revenues | |
|---|---|---|---|---|
| **Province** | **Amount** | **Percent** | **Amount** | **Percent** |
| Manitoba | $ 369,750 | 15% | $1,252,000 | 20% |
| Ontario | 616,250 | 25% | 1,565,000 | 25% |
| Quebec | 986,000 | 40% | 2,191,000 | 35% |
| United States | 493,000 | 20% | 1,252,000 | 20% |
| Total | $2,465,000 | 100% | $6,260,000 | 100% |

The province by province average of the two percentages, calculated above, would be used to allocate the total Taxable Income of $1,467,000 as follows:

| Province | Wages | Revenues | Average | Taxable Income |
|---|---|---|---|---|
| Manitoba | 15% | 20% | 17.5% | $ 256,725 |
| Ontario | 25% | 25% | 25.0% | 366,750 |
| Quebec | 40% | 35% | 37.5% | 550,125 |
| United States | 20% | 20% | 20.0% | 293,400 |
| Total | 100% | 100% | 100.0% | $1,467,000 |

## Self Study Solution Twelve - 6

Kannon's Part I tax payable for the year would be calculated as follows:

| | |
|---|---|
| Base Amount Of Part I Tax [(38%)($473,000)] | $179,740 |
| Federal Tax Abatement [(10%)(88.6%)($473,000)] (Note One) | ( 41,908) |
| Small Business Deduction (Note Two) | ( 47,711) |
| General Rate Reduction (Note Three) | ( 28,846) |
| Part I Tax Payable | $ 61,275 |

**Note One** The federal tax abatement must be reduced because of the foreign business income. The percentage would be calculated as follows:

| | |
|---|---|
| Canadian Wages And Salaries As Percentage Of Total ($560,000 + $642,000) ÷ $1,298,000 | 92.6% |
| Canadian Gross Revenues As Percentage Of Total ($1,200,000 + $1,232,000) ÷ $2,879,000 | 84.5% |

Based on these calculations, the percentage of income on which the federal tax abatement would be available is 88.6 percent [(92.6% + 84.5%) ÷ 2].

**Note Two** Since Kannon's Taxable Capital Employed In Canada during 2018 was greater than $10 million, its small business deduction is reduced. The B component of the ITA 125(5.1) reduction formula is $5,600 [(.00225)($12,488,890 - $10,000,000)]. Given this, the required reduction would be calculated as follows:

[($500,000)($5,600 ÷ $11,250)] = $248,889 **Reduction**

The small business deduction is equal to 19 percent of the least of:

| | |
|---|---|
| • Canadian Active Business Income | $440,000 |
| • Taxable Income | 473,000 |
| • Reduced Annual Business Limit ($500,000 - $248,889) | 251,111 |

The small business deduction would be $47,711 [(19%)($251,111)].

**Note Three** The general rate reduction would be calculated as follows:

| | |
|---|---|
| Taxable Income | $473,000 |
| Amount Eligible For Small Business Deduction | ( 251,111) |
| Full Rate Taxable Income | $221,889 |
| Rate | 13% |
| General Rate Reduction | $ 28,846 |

## Self Study Solution Twelve - 7

The Taxable Income and Tax Payable for the Serendipity Shop Corp. for the year would be calculated as follows:

| | | |
|---|---|---|
| Net Income For Tax Purposes | | $240,000 |
| Deductions: | | |
| Dividends | ($20,000) | |
| Donations | ( 48,000) | ( 68,000) |
| Taxable Income | | $172,000 |

| | |
|---|---|
| Base Amount Of Part I Tax [(38%)($172,000)] | $ 65,360 |
| Federal Tax Abatement [(10%)($172,000)] | ( 17,200) |
| Small Business Deduction (Note) | ( 25,650) |
| General Rate Reduction [(13%)($172,000 - $135,000)] | ( 4,810) |
| Part I Federal Tax Payable | $ 17,700 |

**Note** The small business deduction is based on the least of the following:

| | |
|---|---|
| Active business income | $220,000 |
| Taxable Income | 172,000 |
| Allocated annual business limit | 135,000 |

The small business deduction is equal to $25,650 [(19%)($135,000)].

## Self Study Solution Twelve - 8

### Part A - Net Income For Tax Purposes

The minimum Net Income For Tax Purposes for Borscan Inc. would be calculated as follows:

| | | |
|---|---|---|
| Accounting Income Before Taxes | | $1,275,000 |
| Additions: | | |
| Taxable Capital Gain - Building [(1/2)($625,000 - $500,000 - $100,000)] | $ 12,500 | |
| Taxable Capital Gain - Land ($100,000 - $100,000) | Nil | |
| Recaptured CCA ($500,000 - $350,000) | 150,000 | |
| Amortization Expense | 255,000 | |
| Interest And Penalties - Late Payment | 500 | |
| Charitable Donations | 13,500 | 431,500 |
| | | $1,706,500 |
| Deductions: | | |
| Capital Cost Allowance | ($287,000) | |
| Gain On Expropriated Building (From Income Statement) | ( 25,000) | ( 312,000) |
| Net Income For Tax Purposes | | $1,394,500 |

### Part B - Taxable Income

The minimum Taxable Income for Borscan Inc. would be calculated as follows:

| | |
|---|---|
| Net Income For Tax Purposes | $1,394,500 |
| Dividends Received | ( 25,000) |
| Charitable Donations | ( 13,500) |
| Net Capital Loss Carry Forward (Note) | ( 12,500) |
| Non-Capital Loss Carry Forward | ( 35,000) |
| Taxable Income | $1,308,500 |

**Note** The net capital loss carry forward can be used only to the extent of the taxable capital gain for the year, resulting in a deduction of $12,500. This leaves a remaining net capital loss carry forward of $17,500 ($30,000 - $12,500).

### Part C - Tax Payable

The minimum federal Tax Payable for Borscan Inc. is as follows:

| | |
|---|---|
| Base Amount Of Part I Tax [(38%)($1,308,500)] | $497,230 |
| Federal Tax Abatement [(10%)($1,308,500)] | ( 130,850) |
| General Rate Reduction [(13%)($1,308,500)] | ( 170,105) |
| Federal Tax Payable | $196,275 |

## Self Study Solution Twelve - 9

### *Part A - Net Income*

Net Income For Tax Purposes for Industrial Tools Ltd. would be calculated as follows:

| | | |
|---|---|---|
| Accounting Income Before Taxes | | $2,305,000 |
| Additions: | | |
| Taxable Capital Gain On Building (Note) | $ 37,500 | |
| Taxable Capital Gain On Land ($200,000 - $200,000) | Nil | |
| Recaptured CCA ($875,000 - $625,000) | 250,000 | |
| Charitable Donations | 28,000 | |
| Interest And Penalties | 2,500 | |
| Warranty Reserve | 20,000 | |
| Amortization Expense | 478,000 | 816,000 |
| | | $3,121,000 |
| Deductions: | | |
| Accounting Gain On Building (Given) | ($225,000) | |
| CCA | ( 523,000) | ( 748,000) |
| Net Income For Tax Purposes | | $2,373,000 |

**Note** The taxable capital gain on the building would be calculated as follows:

| | |
|---|---|
| Proceeds Of Disposition ($1,150,000 - $200,000) | $950,000 |
| Adjusted Cost Base ($1,075,000 - $200,000) | ( 875,000) |
| Capital Gain | $ 75,000 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain | $ 37,500 |

As its value has not changed, there is no capital gain on the land.

### *Part B - Taxable Income*

Taxable Income for Industrial Tools Ltd. would be calculated as follows:

| | |
|---|---|
| Net Income For Tax Purposes | $2,373,000 |
| Dividends Received | ( 42,000) |
| Charitable Donations | ( 28,000) |
| Net Capital Loss Carry Forward (Note) | ( 37,500) |
| Taxable Income | $2,265,500 |

**Note** The net capital loss carry forward can be used only to the extent of the taxable capital gain for the year, resulting in a deduction of $37,500. This leaves a remaining net capital loss carry forward of $52,500 ($90,000 - $37,500).

### *Part C - Tax Payable*

Federal Tax Payable for Industrial Tools Ltd. would be calculated as follows:

| | |
|---|---|
| Base Amount Of Part I Tax [(38%)($2,265,500)] | $860,890 |
| Federal Tax Abatement [(10%)($2,265,500)] | ( 226,550) |
| General Rate Reduction [(13%)($2,265,500)] | ( 294,515) |
| Federal Part I Tax Payable | $339,825 |

## Self Study Solution Twelve - 10

### *Part A - Net Income For Tax Purposes*

The minimum Net Income For Tax Purposes would be calculated as follows:

| | |
|---|---|
| Accounting Income Before Taxes | $530,400 |
| Accounting Gain On Sale Of Shares | ( 22,900) |
| Taxable Capital Gain [(1/2)($22,900)] | 11,450 |
| Donations To Registered Canadian Charity | 18,700 |
| Net Income For Tax Purposes | $537,650 |

### *Part B - Taxable Income*

The minimum Taxable Income would be calculated as follows:

| | |
|---|---|
| Net Income For Tax Purposes | $537,650 |
| Donations To Registered Canadian Charity | ( 18,700) |
| Dividends From Taxable Canadian Corporations | ( 9,400) |
| Non-Capital Loss Carry Forward | ( 21,950) |
| Net Capital Loss Carry Forward* | ( 11,450) |
| Taxable Income | $476,150 |

*While there is a net capital loss carry forward of $13,500, the deduction is limited to $11,450, the taxable gain that was recognized during the current year. This leaves a net capital loss carry forward of $2,050.

### *Part C - Tax Payable*

The minimum federal Part I Tax Payable is as follows:

| | |
|---|---|
| Base Amount Of Part I Tax [(38%)($476,150)] | $180,937 |
| Federal Tax Abatement [(10%)(90%)($476,150)] (Note One) | ( 42,854) |
| Small Business Deduction (Note Two) | Nil |
| M&P Deduction (Note Three) | ( 51,136) |
| General Rate Reduction (Note Four) | ( 10,764) |
| Foreign Non-Business Tax Credit (Assumed Equal To Withheld) | ( 4,845) |
| Foreign Business Tax Credit (Assumed Equal To Withheld) | ( 20,700) |
| Part I Tax Payable | $ 50,638 |

**Note One** No income would be allocated to Manitoba as there are no permanent establishments in that province. However, the Manitoba sales would be included in the Ontario total, as the Manitoba customers are serviced through that province. Based on this, the allocation would be as follows:

| Gross Revenues | Amount | Percent |
|---|---|---|
| Ontario And Manitoba | $5,725,000 | 91.0 |
| New York | 565,000 | 9.0 |
| Total | $6,290,000 | 100.0 |

| Salaries And Wages | Amount | Percent |
|---|---|---|
| Ontario | $3,540,000 | 89.0 |
| New York | 438,000 | 11.0 |
| Total | $3,978,000 | 100.0 |

| | |
|---|---|
| Average Ontario Percent [(91.0% + 89.0%) ÷ 2] | 90.0% |
| Average New York Percent [(9.0% + 11.0%) ÷ 2] | 10.0% |
| Total | 100.0% |

Based on the preceding calculations, the federal tax abatement would be $42,854 [(10%)(90%)($476,150)].

**Note Two** There is no small business deduction in the calculation of Part I tax, as Mercury Manufacturing Company is not Canadian controlled.

**Note Three** Since Mercury Manufacturing Company is not a Canadian controlled private corporation, aggregate investment income is not relevant to the M&P calculation. The M&P deduction would be equal to $51,136. This amount is 13 percent of $393,350, which is the lesser of:

| | | |
|---|---|---|
| M & P Profits (Given) | | $410,000 |
| Taxable Income | $476,150 | |
| Less 4 Times Foreign Business Tax Credit [(4)($20,700)] | ( 82,800) | $393,350 |

**Note Four** The general rate reduction would be calculated as follows:

| | |
|---|---|
| Taxable Income | $476,150 |
| Amount Eligible For The M&P Deduction | ( 393,350) |
| Full Rate Taxable Income | $ 82,800 |
| Rate | 13% |
| General Rate Reduction | $ 10,764 |

### *Part D - Foreign Tax Credits*

To calculate the M&P deduction, both the foreign business and non-business tax credits must first be calculated without considering the general rate reduction. This is necessary as otherwise there would be a circular calculation that could not be solved since the general rate reduction calculation requires the income eligible for the M&P deduction and the calculation of the M&P deduction uses the foreign business tax credit.

Although the foreign non-business tax credit is not used directly in the M&P deduction calculation, it is required to calculate the foreign business tax credit which is used.

In Part C of this problem, it is assumed that the credits are equal to the foreign tax withheld so that the alternative calculations were not necessary.

Using the amounts from Part C, the actual foreign tax credits can be calculated as follows:

**Foreign Non-Business Tax Credit** The Tax Otherwise Payable for this calculation would be calculated as follows:

| | |
|---|---|
| Base Amount Of Tax [(38%)($476,150)] | $180,937 |
| Federal Tax Abatement (Note One) | ( 42,854) |
| General Rate Reduction (Note Four) | ( 10,764) |
| Tax Otherwise Payable (Foreign Non-Business Credit) | $127,319 |

Using this information, the foreign non-business tax credit would be the lesser of:

- The Amount Withheld $4,845
- $\left(\dfrac{\text{Foreign Non - Business Income}}{\text{Adjusted Net Income}}\right)$(Part I Tax Otherwise Payable)

$\left(\dfrac{\$32,300}{\$537,650 - \$11,450 - \$9,400}\right)(\$127,319)$ $7,957

The lesser figure would be the actual withholding of $4,845.

**Foreign Business Tax Credit** The Tax Otherwise Payable for this calculation would be calculated as follows:

| | |
|---|---|
| Base Amount Of Tax [(38%)($476,150)] | $180,937 |
| General Rate Reduction (Note Four) | ( 10,764) |
| Tax Otherwise Payable (Foreign Business Credit) | $170,173 |

Using this information, the foreign business tax credit would be the least of:

- The Amount Withheld $20,700
- $\left(\dfrac{\text{Foreign Business Income}}{\text{Adjusted Net Income}}\right)$(Part I Tax Otherwise Payable)

$\left(\dfrac{\$64,200}{\$537,650 - \$11,450 - \$9,400}\right)(\$170,173)$ $21,140

- Tax Otherwise Payable, Less The Foreign Non-Business Tax Credit [($170,173) - $4,845] $165,328

The least of these three figures would be the U.S. taxes withheld of $20,700.

## Chapter 12 Learning Objectives

After completing Chapter 12, you should be able to:

1. Calculate a corporation's Net Income For Tax Purposes (paragraph [P hereafter] 12-1 to 12-4).
2. List the deductions that are available to corporations in calculating Taxable Income (P 12-5 to 12-9).
3. Apply the treatment for different types of dividends received, including the application of the stop loss rules (P 12-10 to 12-23).
4. Calculate the non-capital loss carry over for a corporation (P 12-24 to 12-30).
5. Determine the optimum ordering of the deductions available in calculating corporate Taxable Income (P 12-31 to 12-36).

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6. Allocate corporate Taxable Income to specific provinces (P 12-37 to 12-44).
7. Apply the basic corporate tax rate and explain the effect of the federal tax abatement and the general rate reduction (P 12-45 to 12-51).
8. Calculate provincial Tax Payable for a corporation using a supplied schedule of rates and other data (P 12-52 to 12-62).
9. List the important non-revenue raising goals of the corporate tax system (P 12-63 and 12-64).
10. Explain the rules for determining which corporations and what amounts of income are eligible for the small business deduction (P 12-65 to 12-90).

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11. Calculate the amount of the small business deduction (P 12-91 to 12-101).
12. Calculate the reduction in the small business deduction that is applicable to large CCPCs (P 12-102 to 12-120).
13. Identify personal services corporations and explain their tax treatment (P 12-121 to 12-127).
14. Identify professional corporations and management companies and explain their tax treatment (P 12-128 and 12-129).
15. Calculate the manufacturing and processing profits deduction for all types of corporations (P 12-130 to 12-146).

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16. Calculate the general rate reduction that is available to all corporations and the specific application of the general rate reduction to CCPCs (P 12-147 to 12-160).
17. Calculate the foreign non-business (property) and business income tax credits for corporations and apply the rules that deal with any excess of foreign tax withheld over the foreign tax credit (P 12-161 to 12-173).
18. Describe the refundable journalism labour tax credit (P 12-174 to 12-177).

# CHAPTER 13

## How To Work Through Chapter 13

We recommend the following approach in dealing with the material in this Chapter:

**Note On Current Developments**

- Read the Note at the beginning of the Chapter (in the textbook).

**Integration**

- Read paragraph 13-1 to 13-20.
- Do Exercises Thirteen-1 and Thirteen-2 (in the textbook) and check the solutions in this Study Guide.
- Do Self Study Problem Thirteen-1 which is available on MyLab and check the solution in this Study Guide.
- Read paragraph 13-21 to 13-22.

**Refundable Tax On Aggregate Investment Income**

- Read paragraph 13-23 to 13-38.

**Additional Refundable Tax On Investment Income (ART)**

- Read paragraph 13-39 to 13-42.
- Do Exercise Thirteen-3 and check the solution in this Study Guide.
- Read paragraph 13-43 to 13-53.

**Refundable Portion Of Part I Tax**

- Read paragraph 13-54 to 13-66.
- Do Exercise Thirteen-4 and check the solution in this Study Guide.

**Refundable Part IV Tax On Dividends Received**

- Read paragraph 13-67 to 13-92.
- Do Exercise Thirteen-5 and check the solution in this Study Guide.
- Read paragraph 13-93 and 13-94.

**Designation Of Eligible Dividends**

- Read paragraph 13-95 to 13-98.

**CCPCs And Their GRIP**

- Read paragraph 13-99 to 13-104.
- Do Exercise Thirteen-6 and check the solution in this Study Guide.

**Non-CCPCs And Their LRIP**

- Read paragraph 13-105 to 13-108.

**Part III.1 Tax On Excessive Eligible Dividend Designations (EEDDs)**

- Read paragraph 13-109 to 13-117.

**Refundable Dividend Tax On Hand (RDTOH)**

- Read paragraph 13-118 to 13-128.
- Do Exercise Thirteen-7 and check the solution in this Study Guide.
- Read paragraph 13-129 to 13-143.
- Do Exercise Thirteen-8 and check the solution in this Study Guide.

**Eligible And Non-Eligible RDTOH Balances Defined**

- Read paragraph 13-144 to 13-156.
- Do Exercise Thirteen-9 and check the solution in this Study Guide.
- Do Self Study Problems Thirteen-2 to Thirteen-5 and check the solutions in this Study Guide.

**Economic Impact Of Changes**

- Read paragraph 13-157 to 13-162.

**Example Of RDTOH Calculations**

- Read paragraph 13-163 to 13-174

**Working Through Large Corporate Problems**

- Read paragraph 13-175 and 13-176.
- Do Self Study Problems Thirteen-6 to Thirteen-9 and check the solutions in this Study Guide.

**Sample Corporate Tax Return**

- Read the Sample Corporate Tax Return found on in this Study Guide. The complete tax return is available on MyLab in two formats, a T2 ProFile return file and a .PDF file.

**To Complete This Chapter**

- If you would like more practice in problem solving, do the Supplementary Self Study Problems for the chapter. These problems and solutions are available on MyLab.
- Review the Key Terms Used In This Chapter in the textbook at the end of Chapter 13. Consult the Glossary for the meaning of any key terms you do not know.
- Test yourself with the Chapter 13 Glossary Flashcards available on MyLab.
- Ensure you have achieved the Chapter 13 Learning Objectives listed in this Study Guide.
- As a review, we recommend you view the PowerPoint presentation for Chapter 13 that is on MyLab.

**Practice Examination**

- Write the Practice Examination for Chapter 13 that is on MyLab. Mark your examination using the Practice Examination Solution that is on MyLab.

## Sample Corporate Tax Return

The following simplified example contains a T2 corporate income tax return completed using the ProFile T2 corporate tax preparation program from Intuit Canada. It contains 2018 (not 2019) information as the current Profile software release does not support fiscal periods ending after April 30, 2019. Shortly after the first filing version of the 2019 Intuit ProFile software is available in January, 2020, the updated 2019 version of this problem will be available on MyLab at:

**http://www.pearsonmylabandmastering.com**

As this example is designed to illustrate corporate tax return calculations, limited GIFI (General Index of Financial Information) data has been included. The relevant T2 schedule or form name is provided in square brackets to make it easier for users to find where the information is input. Note that capital dividends are covered in detail in Chapter 14.

## Sample Files On MyLab

### *To View The Tax Return Files*

The complete sample tax return is available on MyLab in two versions, a T2 ProFile return file and a .PDF file.

To view the ProFile return file (with a .GT2 extension), you must have the ProFile program installed. For information on how to obtain the program for free, see MyLab.

To view the .PDF files, you must have the Adobe Reader program installed. This program can be installed for free from the Adobe website (www.adobe.com).

## Sample Problem Data

> **Note**: The government's Crown Copyright does not permit us to use fake Business Numbers in software examples. To reduce the number of ProFile's error messages because of this, we have used NR (for not registered) in the Business Number field.

On the ProFile schedule titled "Info", the Filing question "Complete return from GIFI?" is answered Yes by default. Click the No box and you can ignore the GIFI requirements.

MetroFaux Inc. is a Canadian controlled private corporation based in Saskatoon that manufactures metal and composite office furniture. Its head office is located at 123 ABC Avenue, Saskatoon, SK S7G 1A1, phone number (306)111-1111. The signing officer and contact person is the President of the company, Jack Saskatoon. MetroFaux Inc. was incorporated on August 28, 1977.

Most of its income is earned from active business in Canada. The Company has no associated corporations. Although the company has a sophisticated website, it is only for information purposes. It has no income from a web page or website. [Schedule 88 is not applicable.]

As at December 31, 2017, the following information applied to MetroFaux Inc:

| | |
|---|---:|
| Taxable Capital Employed In Canada [Info] | $1,590,000 |
| RDTOH [T2, line 460] | Nil |
| Dividends Declared And Paid During 2017 | Nil |
| GRIP Balance [Schedule 53] | 276,000 |

During the taxation year ending December 31, 2018, the condensed before tax Income Statement of MetroFaux Inc. was prepared in accordance with the International Financial Reporting Standards (IFRS). In condensed form it is as follows:

**MetroFaux Inc.**
**Condensed Income Statement**
**Year Ending December 31, 2018**

| | | |
|---|---:|---:|
| Sales | $3,980,000 | |
| Gain On Building Sale | 160,000 | $4,140,000 |
| Amortization Expense | $ 607,000 | |
| Other Expenses Excluding Taxes | 1,773,000 | 2,380,000 |
| Accounting Income Before Taxes | | $1,760,000 |

### *Preliminary GIFI Procedures*

On the ProFile schedule titled "Info", the Filing question "Complete return from GIFI?" is answered Yes by default. Click the No box. Ignore the GIFI requirements except as follows:

- On GIFI Schedule 125 (Income Statement), input the total sales as "Trade sales of goods and services" (Code 8000) and the Gain On Building Sale as "Realized gains / losses on disposal of assets" (Code 8210) from the drop down menu under Revenues. Input the

Amortization Expense as "Amortization of tangible assets" (Code 8670) and the Other Expenses as "Other expenses" (Code 9270) from the drop down menu under Operating Expenses.

- On GIFI Schedule 100 (Balance Sheet), input the Net Income figure as "Cash and deposits" (Code 1000) in order to make the total assets equal to the total liabilities and equity.

Although this will not properly complete the GIFI statements, it will eliminate the warning messages that would otherwise be generated when the Net Income figure and Amortization Expense are input on Schedule 1. These GIFI entries will have no effect on the calculations in the tax return. To prevent audit warnings, S141, "Notes Checklist", has to be completed. Assume there are no notes to the financial statements and answer "No" to any other relevant questions.

**Other Information**:

1. Expenses include interest and penalties of $2,300 resulting from late income tax installments and a failure to file the 2017 tax return within the prescribed time period. [Schedule 1]
2. Expenses include a deduction for charitable donations to the Cancer Research Society in the amount of $15,000. [Schedule 2]
3. Revenues include eligible dividends of $36,000 from Canadian Tax Save Inc., a taxable Canadian corporation. MetroFaux Inc. has no association with Canadian Tax Save Inc. and considers the dividends portfolio dividends. [Schedule 3. Note that under the GRIP/LRIP double column, "Column F deduction type" = s. 112 and $36,000 must be placed in the "Indicate eligible dividends" column.]
4. The Company paid $100,000 in taxable eligible dividends during 2018. [Schedule 3]
5. The Company has available a non-capital loss carry over from the previous year of $56,000 [S4Supp]. The net capital loss carry forward from 2015 is $22,500 (1/2 of $45,000). [Schedule 4 - note 100 percent figures are used for the capital loss]
6. During 2018, the Company earned $97,000 of interest income on bonds purchased in 2017 that mature in 2022. [Schedule 7]
7. Amortization expense on the Income Statement amounts to $607,000 The opening UCC balance was $905,000 for Class 8, $800,000 for Class 10 and $429,000 for Class 53. The only fixed asset acquisition was $100,000 in Class 53 manufacturing equipment on May 1, 2018. There were no dispositions in Classes 8 or 10. [Schedule 8 flows to Schedule 1]
8. The Gain On Building Sale resulted from the sale of a building for proceeds of $792,000 of which $120,000 was allocated to the land. The building at 456 DEF Street, Regina, Saskatchewan S7G 1A1, was acquired on August 28, 2009 for $764,000, of which $100,000 was allocated to the land. The sales office of the Company had been located in this building and the sales office has subsequently moved to leased space in Saskatoon. As the Company leases all of its other buildings and equipment, the building was the only asset in Class 1. The Undepreciated Capital Cost of this class prior to the disposition of the building was $514,000. [Schedules 1, 6 and 8]
9. Information related to Canadian manufacturing and processing activities for the year is as follows: [Schedule 27]

| | |
|---|---|
| Cost of capital [(10% of $6,000,000) + ($200,000 in rental costs)] | $ 800,000 |
| Portion of capital used in M&P activities | 500,000 |
| Cost of labour | 1,000,000 |
| Portion of labour used in M&P activities | 760,000 |

10. All of the common shares of MetroFaux Inc. are held by the president, Jack Saskatoon (SIN 527-000-582). [Schedule 50]

11. The beginning balance in the Company's capital dividend account is nil [CDA]. Note that capital dividends are covered in detail in Chapter 14.

12. The Company paid one federal income tax instalment of $212,000 on September 1, 2018 [TaxPaid].

## Completed Tax Return

The complete sample tax return is available on MyLab in two versions, a T2 ProFile return file and a .PDF file.

## Notes On Sample Corporate Tax Return

### *Loss Carry Forwards*

The losses of prior taxation years deducted in the calculation of Taxable Income consist of the non-capital loss of $56,000 and a $14,000 net capital loss. As calculated on Schedule 4, the net capital loss carry forward deduction is limited by the $28,000 capital gain for the year and leaves a capital loss carry forward of $17,000. Note Schedule 4 uses the 100 percent amounts. There is no non-capital loss carry forward remaining.

### *Building Sale*

The $160,000 Gain On Building Sale is deducted on Schedule 1 as the tax effects of the disposition are included in Net Income For Tax Purposes. As calculated on Schedule 6, the taxable capital gain on the building sale is $14,000 [(1/2)($792,000 - $764,000)].

As calculated on Schedule 8, the recapture of CCA on the building is equal to $150,000 ($664,000 - $514,000). This is shown as an addition on Schedule 1, separate from the CCA.

### *Aggregate Investment Income*

As calculated on Schedule 7, Part 1, the aggregate investment income of $97,000 consists of:

- the taxable capital gains of $14,000, less
- the $14,000 net capital loss carry forward claimed, plus
- net property income of $133,000 (dividends received of $36,000 plus interest income of $97,000), less
- taxable dividends deductible of $36,000.

This figure is used in calculating the refundable portion of Part I tax.

### *Active Business Income*

As calculated on Schedule 7, Part 5, income from active business carried on in Canada of $1,580,800 is Net Income For Tax Purposes of $1,727,800 less the sum of:

- the taxable capital gains of $14,000, plus
- net property income of $133,000 (dividends received of $36,000 plus interest income of $97,000).

This figure is used in the small business deduction calculation and in Schedule 27 for the M&P deduction.

### *M&P Labour*

As the grossed up M&P Labour of $1,013,333 [(100/75)($760,000)] is greater than the $1,000,000 Cost of Labour, M&P Labour in the Schedule 27, Part 7 calculation is limited to $1,000,000.

As mentioned in the text, although the effect of the federal M&P deduction has been negated by the general rate reduction, there are still provincial M&P tax reductions available. In this example, MetroFaux Inc. is eligible for the Saskatchewan M&P tax reduction. (See Schedule 404.)

***Capital Dividend Account***
The balance in the Capital Dividend Account is $14,000 [(1/2)($692,000 - $664,000)]. A tax free capital dividend of $14,000 could have been paid if form T2054 had been filed. (See Chapter 14.)

***GRIP***
As no dividends were declared or paid during 2017, no eligible dividends could have been paid. As a result, Schedule 53 has no amount on line 300, "Eligible dividends paid in the previous tax year".

## Solutions to Chapter Thirteen Exercises

***Exercise Thirteen - 1 Solution***
If she incorporates, the corporation will pay taxes of $15,000 [(15%)($100,000)], leaving $85,000 to be distributed as dividends. Her individual Tax Payable on these non-eligible dividends would be calculated as follows:

| | |
|---|---|
| Non-Eligible Dividends Received | $ 85,000 |
| Gross Up [(15%)($85,000)] | 12,750 |
| Grossed Up Dividends | $97,750 |
| Personal Tax Rate | 45% |
| Tax Before Credit | $ 43,988 |
| Dividend Tax Credit [(9/13 + 30%)($12,750)] | ( 12,652) |
| Tax Payable On Dividends | $31,336 |

The net after tax retention would be $53,664 ($85,000 - $31,336). This compares to $55,000 [($100,000)(1 - .45)] retained if a corporation is not used. Clearly the use of a corporation is not desirable in this situation. This result reflects the fact that the corporate tax rate is above the 13.04 percent required for integration and the provincial dividend tax credit is below the 30.8 percent required for integration.

***Exercise Thirteen - 2 Solution***
If he incorporates, the corporation will pay taxes of $30,000 [(30%)($100,000)], leaving $70,000 to be distributed as dividends. His individual Tax Payable on these eligible dividends would be calculated as follows:

| | |
|---|---|
| Eligible Dividends Received | $70,000 |
| Gross Up [(38%)($70,000)] | 26,600 |
| Grossed Up Dividends | $96,600 |
| Personal Tax Rate | 42% |
| Tax Before Credit | $40,572 |
| Dividend Tax Credit [(6/11 + 28%)($26,600)] | ( 21,957) |
| Tax Payable On Dividends | $18,615 |

The net after tax retention would be $51,385 ($70,000 - $18,615). This compares to $58,000 [($100,000)(1 - .42)] retained if a corporation is not used. Clearly the use of a corporation is not desirable in this situation. While the corporate tax rate of 30 percent is greater than the required 27.54 percent, the real problem here is the fact that the provincial dividend tax credit of 28 percent is significantly below the required 45.5 percent.

### *Exercise Thirteen - 3 Solution*

Zircon's Taxable Income would be calculated as follows:

| | |
|---|---|
| Net Income For Tax Purposes | $281,000 |
| Dividends From Taxable Canadian Corporations | ( 22,000) |
| Net Capital Loss Carry Forward | ( 26,000) |
| Non-Capital Loss Carry Forward | ( 23,000) |
| Taxable Income | $210,000 |

Zircon's amount eligible for the small business deduction of $198,000 is the least of active business income of $198,000, Taxable Income of $210,000, and the annual business limit of $500,000.

Given these calculations, Zircon's additional refundable tax on investment income would be calculated using the lesser of:

| | | |
|---|---|---|
| Aggregate Investment Income | | |
| Taxable Capital Gains | $46,000 | |
| Net Capital Loss Deducted | ( 26,000) | |
| Interest Income | 15,000 | $35,000 |
| Taxable Income | $210,000 | |
| Amount Eligible For SBD | ( 198,000) | $12,000 |

The additional refundable tax on investment income would be $1,280 [(10-2/3%)($12,000)]. Note that the Taxable Income limit is $23,000 ($35,000 - $12,000) less than the Aggregate Investment Income. This difference is the result of the deduction of the $23,000 non-capital loss carry forward.

### *Exercise Thirteen - 4 Solution*

If Ms. Nicastro receives the income directly, she will retain $49,000 [($100,000)(1 - .51)]. Alternatively, if the investments are transferred to a corporation, the results would be as follows:

| | |
|---|---|
| Corporate Investment Income | $100,000 |
| Corporate Tax At 52 Percent | ( 52,000) |
| After Tax Income | $ 48,000 |
| Dividend Refund [($48,000 ÷ .61667) - $48,000] | 29,837 |
| Non-Eligible Dividends Paid To Ms. Nicastro | $ 77,837 |

| | |
|---|---|
| Non-Eligible Dividends Received | $ 77,837 |
| Gross Up Of 15 Percent | 11,676 |
| Personal Taxable Income | $ 89,513 |
| Personal Tax Rate | 51% |
| Tax Payable Before Dividend Tax Credit | $ 45,652 |
| Dividend Tax Credit [(9/13 + 30%)($11,676)] | ( 11,586) |
| Personal Tax Payable With Corporation | $ 34,066 |

| | |
|---|---|
| Non-Eligible Dividends Received | $ 77,837 |
| Personal Tax Payable | ( 34,066) |
| After Tax Cash Retained With Corporation | $ 43,771 |

There would be no tax deferral with the corporation as the corporate taxes of $52,000 are $1,000 more than the $51,000 she would pay on direct receipt of the income. In addition, the use of a corporation would reduce the after tax funds retained by $5,229 ($43,771 vs. $49,000). There is clearly a disadvantage resulting from the use of a corporation.

### Exercise Thirteen - 5 Solution

The amount of Part IV Tax Payable would be calculated as follows:

| | |
|---|---|
| Tax On Portfolio Investments [(38-1/3%)($14,000)] | $5,367 |
| Tax On Emerald Inc. Dividends | Nil |
| Tax On Ruby Inc. Dividends [(30%)($15,000)] | 4,500 |
| Part IV Tax Payable | $9,867 |

### Exercise Thirteen - 6 Solution

Since Taxable Income is greater than Aggregate Investment Income (comparison used in D in the following table), the 2019 ending balance in GRIP will be calculated as follows:

| | | |
|---|---|---|
| C - GRIP Balance At End Of 2018 | | $ 35,000 |
| D - Taxable Income | $960,000 | |
| Income Eligible For SBD ($42,750 ÷ 19%) | ( 225,000) | |
| Aggregate Investment Income ($65,000 + $23,000 - $14,000) | ( 74,000) | |
| Adjusted Taxable Income | $661,000 | |
| Rate | 72% | 475,920 |
| E - Eligible Dividends Received | | 85,000 |
| G - Eligible Dividends Designated in 2018 | | ( 25,000) |
| GRIP At End Of 2019 | | $570,920 |

The eligible dividends paid during 2019 will be deducted from the GRIP in 2020.

Note that, in this Exercise, there is no ADJUSTED Aggregate Investment Income grind to the annual business limit for the small business deduction. This is because the 2019 grind would be based on the 2018 ADJUSTED Aggregate Investment Income which is less than $50,000.

### Exercise Thirteen - 7 Solution

The opening balance in the single RDTOH account is $76,667 ($153,333 - $76,666). This is the relevant RDTOH value for all 3 Cases.

**Case 1**

| | |
|---|---|
| Opening Balance In RDTOH Account | $76,667 |
| Transitional Eligible RDTOH - Lesser Of: | |
| • Opening Balance RDTOH = $76,667 | |
| • No GRIP Opening Balance = Nil | Nil |
| Transitional Non-Eligible RDTOH | $76,667 |

| | |
|---|---|
| Transitional Eligible RDTOH | Nil |
| Transitional Non-Eligible RDTOH | $76,667 |

**Case 2**

| | |
|---|---|
| Opening Balance In RDTOH Account | $76,667 |
| Transitional Eligible RDTOH - Lesser Of: | |
| • Opening Balance RDTOH = $76,667 | |
| • [(38-1/3%)(Opening GRIP Balance)] | |
| [(38-1/3%)($300,000 - $200,000)] = $38,333 | ( 38,333) |
| Transitional Non-Eligible RDTOH | $38,334 |
| Transitional Eligible RDTOH | $38,333 |
| Transitional Non-Eligible RDTOH | 38,334 |

**Case 3**

| | |
|---|---|
| Opening Balance In RDTOH Account | $76,667 |
| Transitional Eligible RDTOH - Lesser Of: | |
| • Opening Balance RDTOH = $76,667 | |
| • [(38-1/3%)(Opening GRIP Balance)] | |
| [(38-1/3%)($500,000 - $200,000)] = $115,000 | ( 76,667) |
| Transitional Non-Eligible RDTOH | Nil |
| Transitional Eligible RDTOH | $76,667 |
| Transitional Non-Eligible RDTOH | Nil |

### *Exercise Thirteen - 8 Solution*

The refundable amount of Debut Inc.'s Part I tax would be the least of the following three figures:

| | | |
|---|---|---|
| Foreign Non-Business Income (100 Percent) | | $15,000 |
| Taxable Capital Gains [(1/2)($38,250)] | | 19,125 |
| Net Rental Income | | 6,500 |
| Interest Income | | 9,200 |
| Net Capital Loss Carry Forward Deducted | | ( 9,000) |
| Aggregate Investment Income Under ITA 129(4) | | $40,825 |
| Rate | | 30-2/3% |
| Amount Before Foreign Income Adjustment | | $12,520 |
| Deduct Excess Of: | | |
| Foreign Non-Business Tax Credit | ($ 750) | |
| Over 8 Percent Of Foreign Non-Business Income [(8%)($15,000)] | 1,200 | Nil |
| Amount Under ITA 129(4)(a)(i) | | $12,520 |

| | |
|---|---|
| Taxable Income ($121,825 - $22,000 - $9,000) | $90,825 |
| Deduct: | |
| Amount Eligible For The Small Business Deduction ($9,500 ÷ 19%) | ( 50,000) |
| [(100 ÷ 38-2/3)($750)] Foreign Non-Business Tax Credit | ( 1,940) |
| Adjusted Taxable Income | $38,885 |
| Rate | 30-2/3% |
| Amount Under ITA 129(4)(a)(ii) | $11,925 |

| | |
|---|---|
| Amount Under ITA 129(4)(a)(iii) = Part I Tax Payable (Given) | $19,536 |

The least of these three amounts is $11,925, and this would be the refundable portion of Part I tax for the year.

***Exercise Thirteen - 9 Solution***

**Dividend Refund On Eligible Dividends** The dividend refund on eligible dividends would be $76,667, the lesser of:

- $76,667 (38-1/3% of the $200,000 of eligible dividends paid in 2019)
- $134,167 (the balance in the Eligible RDTOH on December 31, 2019)

While the Exercise does not require this information, the corporation would start 2020 with a $150,000 ($350,000 - $200,000) balance in its GRIP.

**Dividend Refund On Non-Eligible Dividends** Component 1 of the dividend refund on non-eligible dividends would be $95,833, the lesser of:

- $153,333 (38-1/3% of the $400,000 of non-eligible dividends paid in 2019)
- $95,833 (the balance in the Non-Eligible RDTOH on December 31, 2019)

With respect to Component 2, 38-1/3% of the $400,000 of non-eligible dividends paid during 2019 exceeds the balance in the Non-Eligible RDTOH by $57,500 ($153,333 - $95,833). Given this, Component 2 would be equal to the lesser of:

- the excess of $57,500; and
- $57,500 ($134,167 - $76,667), the balance left in the Eligible RDTOH after the refund on eligible dividends paid.

The purpose of Component 2 is to allow access to the Eligible RDTOH for dividend refunds on the payment of non-eligible dividends when there is no balance left in the Non-Eligible RDTOH.

The total refund resulting from the payment of non-eligible dividends is $153,333 ($95,833 + $57,500). Note that $153,333 is equal to 38-1/3 percent of the $400,000 in non-eligible dividends paid.

You should also be aware that the combined refund of $230,000 ($76,667 + $153,333) is equal to the combined balances ($134,167 + $95,833) in the two RDTOH accounts.

## Self Study Solution Thirteen - 1

The required calculations would be as follows:

**Corporate Taxes**

| | |
|---|---|
| Income For The Year | $50,000 |
| Corporate Taxes (17%) | ( 8,500) |
| Income Available For Dividends | $41,500 |

**Personal Taxes On Dividends**

| | |
|---|---|
| Dividend Income | $41,500 |
| Gross Up (15%) | 6,225 |
| Taxable Dividends | $47,725 |
| | |
| Tax Payable Before Dividend Tax Credit [(33% + 16%)($47,725)] | $23,385 |
| Dividend Tax Credit [(9/13 + 4/13)($6,225)] | ( 6,225) |
| Personal Tax Payable | $17,160 |

**Total Taxes On Corporate Flow Through**

| | |
|---|---|
| Corporate Taxes | $ 8,500 |
| Personal Taxes | 17,160 |
| Total Taxes | $25,660 |

**Total Taxes On Income Earned Directly**

| | |
|---|---|
| Income For The Year | $50,000 |
| Combined Federal/Provincial Tax Rate (33% + 16%) | 49% |
| Personal Tax Payable | $24,500 |

While the provincial dividend tax credit is at the rate required for perfect integration, the combined corporate federal/provincial tax rate is above the 13.04 percent that is required to achieve this goal. The result is that taxes on $50,000 of income flowed through a corporation is $1,160 ($25,660 - $24,500) higher than the taxes on the same $50,000 of income received directly.

## Self Study Solution Thirteen - 2

The opening balance in the single RDTOH account is $95,833 ($115,000 - $19,167). This is the relevant opening balance RDTOH value for all three Cases.

**Case 1**

| | |
|---|---|
| Opening Balance In RDTOH Account | $95,833 |
| Transitional Eligible RDTOH - Lesser Of: | |
| • Opening Balance RDTOH = $95,833 | |
| • No GRIP Opening Balance = Nil | Nil |
| Transitional Non-Eligible RDTOH | $95,833 |

| | |
|---|---|
| Transitional Eligible RDTOH | Nil |
| Transitional Non-Eligible RDTOH | $95,833 |

**Case 2**

| | |
|---|---|
| Opening Balance In RDTOH Account | $95,833 |
| Transitional Eligible RDTOH - Lesser Of: | |
| • $95,833 - Opening Balance RDTOH | |
| • $11,500 [(38-1/3%)($120,000 - $90,000)] | ( 11,500) |
| Transitional Non-Eligible RDTOH | $84,333 |

| | |
|---|---|
| Transitional Eligible RDTOH | $ 11,500 |
| Transitional Non-Eligible RDTOH | 84,333 |

**Case 3**

| | |
|---|---|
| Opening Balance In RDTOH Account | $95,833 |
| Transitional Eligible RDTOH - Lesser Of: | |
| • $95,833 - Opening Balance RDTOH | |
| • $103,500 [(38-1/3%)($390,000 - $120,000)] | ( 95,833) |
| Transitional Non-Eligible RDTOH | Nil |

| | |
|---|---|
| Transitional Eligible RDTOH | $95,833 |
| Transitional Non-Eligible RDTOH | Nil |

## Self Study Solution Thirteen - 3

**Dividend Refund On Eligible Dividends** The refund on eligible dividends would be the lesser of:

- $115,000 (38-1/3 percent of the $300,000 of eligible dividends paid in 2019)
- $201,250 (the balance in the Eligible RDTOH on December 31, 2019)

While the problem does not require this information, the corporation would start 2020 with a $225,000 ($525,000 - $300,000) balance in its GRIP.

**Dividend Refund On Non-Eligible Dividends** Component 1 of the refund on non-eligible dividends would be the lesser of:

- $345,000 (38-1/3 percent of the $600,000 of non-eligible dividends paid in 2019)
- $143,750 (the balance in the Non-Eligible RDTOH on December 31, 2019)

Component 2 would be equal to $86,250, the excess of $230,000, 38-1/3 percent of the $600,000 of non-eligible dividends paid during 2019, over $143,750, the balance in the Non-Eligible RDTOH on December 31, 2019. Note that this component of the refund will have to be taken out of the corporation's Eligible RDTOH.

The total refund resulting from the payment of non-eligible dividends is $230,000 ($143,750 + $86,250). Note that $230,000 is equal to 38-1/3 percent of the $600,000 in non-eligible dividends paid.

You should also be aware that the combined refund of $345,000 ($115,000 + $230,000) is equal to the combined balances ($201,250 + $143,750) in the two RDTOH accounts.

## Self Study Solution Thirteen - 4

### *Part A - Transitional RDTOH Balances*

As FOL has no GRIP balance on December 31, 2018, the transitional Eligible RDTOH would be nil, with all of the old RDTOH becoming a transitional Non-Eligible RDTOH of $2,000.

Similarly, SHI had no December 31, 2018 GRIP balance. Again, this would result in a transitional Eligible RDTOH of nil, with all of the old RDTOH becoming a transitional Non-Eligible RDTOH of $10,000.

### *Part B - Required Balances For FOL*

For FOL, the only refundable taxes paid in 2019 would be on the $7,000 of Canadian interest income. This amount would be added to the Non-Eligible RDTOH for this corporation. Given this, the December 31, 2019 Non-Eligible RDTOH balance for FOL would be as follows:

| | |
|---|---:|
| Transitional Non-Eligible RDTOH | $2,000 |
| Refundable Portion Of Part I Tax [(30-2/3%)($7,000)]* | 2,147 |
| December 31, 2019 Non-Eligible RDTOH | $4,147 |

*While the full calculation of the refundable portion of Part I tax would require selecting the least of the amounts described in ITA 129(4)(a)(i), (ii), and (iii), the problem asks you to assume that refundable portion of Part I tax is equal to 30-2/3 percent of Aggregate Investment Income.

Based on this information, FOL's 2019 dividend refund would be $4,147, the lesser of:

- $28,750 [(38-1/3%)($75,000)]; and
- $4,147, the balance in the Non-Eligible RDTOH.

### *Part C - Required Balance For SHI*

For 2019, SHI would pay Part IV tax as follows:

| | |
|---|---|
| Part IV Tax Payable On Eligible Dividends From Royal Bank [(38-1/3%)($8,000)] | $3,067 |
| Part IV Tax Payable SHI's Share Of FOL's Dividend Refund On Payment Of Non-Eligible Dividends (100%) - Part B | 4,147 |
| Part IV Tax Payable | $7,214 |

SHI's Part I refundable taxes would be as follows:

| | |
|---|---|
| Interest Income | $12,000 |
| Taxable Capital Gain [(1/2)($47,250)] | 23,625 |
| Aggregate Investment Income | $35,625 |
| Rate | 30-2/3% |
| Refundable Portion Of SHI's Part I Tax Payable | $10,925 |

Turning to SHI's RDTOH balances, the transitional Eligible RDTOH balance for the corporation was nil. The only 2019 addition would be $3,067 in Part IV taxes on the eligible dividends received by SHI on portfolio investments. This would leave a balance of $3,067 (Nil + $3,067).

As none of FOL's dividends were designated as eligible, the $4,147 in Part IV taxes paid on the FOL's non-eligible dividends would be added to SHI's Non-Eligible RDTOH.

The December 31, 2019 balances in SHI's RDTOH accounts would be as follows:

| | |
|---|---|
| Transitional Eligible RDTOH | Nil |
| Part IV Tax On Royal Bank Eligible Dividends | $3,067 |
| December 31, 2019 Eligible RDTOH | $3,067 |

| | |
|---|---|
| Transitional Non-Eligible RDTOH | $10,000 |
| Part IV Tax On FOL's Non-Eligible Dividends | 4,147 |
| Part I Refundable Tax On Aggregate Investment Income | 10,925 |
| December 31, 2019 Non-Eligible RDTOH | $25,072 |

### *Part D - SHI's Dividend Refund*

The amount of dividends that can be designated as eligible is limited by the corporation's GRIP. The balance in this account is $8,000, the initial balance of nil, plus the $8,000 in eligible dividends received from Royal Bank. This means that the maximum amount of dividends that can be designated as eligible is $8,000 and the dividend refund on these dividends would be $3,067, the lesser of:

- $3,067 [(38-1/3%)($8,000)]; and
- $3,067, the balance in SHI's Eligible RDTOH.

With $8,000 of the dividends paid designated as eligible, the remaining $42,000 ($50,000 - $8,000) would be non-eligible. The dividend refund on these dividends would be $16,100, the lesser of:

- $16,100 [(38-1/3%)($42,000)]; and
- $25,072, the balance in SHI's Non-Eligible RDTOH.

SHI's total dividend refund would be as follows:

| | |
|---|---|
| Dividend Refund On Eligible Dividends | $ 3,067 |
| Dividend Refund On Non-Eligible Dividends | 16,100 |
| Total Dividend Refund | $19,167 |

## Self Study Solution Thirteen - 5

**Note To Students** The assumed Tax Payable of $23,960 cannot be verified based on the information in the problem. It is, however, a reasonable figure given the information that is available.

### *Part A - Transitional RDTOH Balances*

For purposes of determining the transitional RDTOH balances, the corporation's single RDTOH balance was $4,150 ($6,450 - $2,300). As the corporation had no GRIP balance, the transitional Eligible RDTOH will be nil, with all of the $4,150 balance allocated to the transitional Non-Eligible RDTOH.

### *Part B - Part IV Tax Payable*

The Part IV Tax Payable for Insal Ltd. would be calculated as follows:

| | |
|---|---|
| Dividend Refund Received By Dorne Inc. | $8,400 |
| Insal's Percentage Of Ownership | 45% |
| Part IV Tax Payable On Dorne's Non-Eligible Dividends | $3,780 |
| Part IV Tax Payable On Enbridge's Eligible Dividends [(38-1/3%)($6,200)] | 2,377 |
| Part IV Tax Payable | $6,157 |

### *Part C - Part I Refundable Tax Paid*

The refundable portion of the Part I tax would be the least of the following amounts:

| | |
|---|---|
| Taxable Capital Gain [(1/2)($24,600)] | $12,300 |
| Net Rental Income | 4,200 |
| Aggregate Investment Income | $16,500 |
| Rate | 30-2/3% |
| **ITA 129(4)(a)(i)** | $ 5,060 |
| Taxable Income | $123,400 |
| Amount Eligible For Small Business Deduction (See Note) | ( 45,000) |
| Total | $ 78,400 |
| Rate | 30-2/3% |
| **ITA 129(4)(a)(ii)** | $ 24,043 |
| **ITA 129(4)(a)(iii)** Part I Tax Payable - Given | $ 23,960 |

**Note** As the problem indicates that Insal's Tax Payable was reduced by a small business deduction of $8,550, the amount eligible for this deduction must have been $45,000 ($8,550 ÷ 19%).

The refundable portion of Part I tax is equal to $5,060, which is the least of the preceding three amounts.

### Part D - Eligible RDTOH

As noted in Part A, Insal's transitional Eligible RDTOH is nil. Given this, the December 31, 2019 Eligible RDTOH would be:

| | |
|---|---|
| Transitional Eligible RDTOH | $ Nil |
| Part IV Taxes Paid On Enbridge's Eligible Dividends | 2,377 |
| December 31, 2019 Eligible RDTOH | $2,377 |

As none of the dividends paid by Dorne were designated as eligible, the Part IV tax paid on these dividends cannot be added to Insal's Eligible RDTOH. While the $6,200 of eligible dividends received from Enbridge can be added to Insal's GRIP, the non-eligible dividends received from Dorne cannot be.

### Part D - Non-Eligible RDTOH

Insal's December 31, 2019 Non-Eligible RDTOH would be calculated as follows:

| | |
|---|---|
| Transitional Non-Eligible RDTOH | $ 4,150 |
| Part IV Tax Payable On Dorne's Non-Eligible Dividends | 3,780 |
| Refundable Part I Tax | 5,060 |
| December 31, 2019 Non-Eligible RDTOH | $12,990 |

### Part E - Dividend Refund

The maximum amount of dividends that can be designated as eligible is limited by Insal's GRIP. We know that the initial 2019 balance here was nil and that the $6,200 of eligible dividends received from Enbridge would be added. There is also the possibility that there would a further amount added as a result of some of the corporation's income not being eligible for the small business deduction. (This amount cannot be determined based on the information in the problem.)

However, given Insal's policy of designating dividends as eligible only when a dividend refund is available, a further addition to the GRIP would not be relevant in this problem. This is because a dividend refund will only be available for the balance in the Eligible RDTOH, an amount of $2,377. Based on this, the eligible dividend designation will be for $6,200, the amount of the eligible dividends received. The refund on these dividends will be $2,377 [($6,200)(38-1/3%)].

The remaining dividends of $12,050 ($18,250 - $6,200) will be non-eligible.

The refund on these non-eligible dividends would be $4,619, the lesser of:

- $4,619 [(38-1/3%)($12,050)]; and
- $12,990, the balance in the Non-Eligible RDTOH.

The total dividend refund would be as follows:

| | |
|---|---|
| Dividend Refund On Eligible Dividends | $2,377 |
| Dividend Refund On Non-Eligible Dividends | 4,619 |
| Total Dividend Refund | $6,996 |

## Self Study Solution Thirteen - 6

### *Part A - Part I Tax Payable*

The required calculations to determine Part I federal Tax Payable are as follows:

| | |
|---|---|
| Net Income For Tax Purposes | $473,900 |
| Dividends ($108,000 + $56,000) | ( 164,000) |
| Taxable Income | $309,900 |

| | |
|---|---|
| Base Amount Of Part I Tax [(38%)($309,900)] | $117,762 |
| Federal Tax Abatement [(10%)($309,900)] | ( 30,990) |
| Small Business Deduction (Note One) | ( 41,097) |
| Additional Refundable Tax On Investment Income (Note Two) | 9,984 |
| General Rate Reduction (Note Three) | Nil |
| Part I Federal Tax Payable | $ 55,659 |

**Note One** The small business deduction is 19 percent of the least of the following three amounts:

| | | |
|---|---|---|
| 1. | Active Business Income | $216,300 |
| 2. | Taxable Income (no foreign tax credit adjustment) | $309,900 |
| 3. | Allocated Annual Business Limit ($500,000 - $200,000) | $300,000 |

The lowest of these figures is the active business income of $216,300 and this gives a small business deduction of $41,097 [(19%)($216,300)].

**Note Two** The aggregate investment income of $93,600 is calculated as follows:

| | |
|---|---|
| Interest On Government Bonds | $ 36,300 |
| Taxable Capital Gains | 57,300 |
| Aggregate Investment Income | $ 93,600 |

The ITA 123.3 refundable tax (ART) is 10-2/3 percent of the lesser of:

| | | | |
|---|---|---|---|
| 1. | Aggregate Investment Income | | $93,600 |
| 2. | Taxable Income | $309,900 | |
| | Deduct: Amount Eligible For The SBD | ( 216,300) | $93,600 |

The ITA 123.3 tax on aggregate investment income is $9,984 [(10-2/3%)($93,600)].

**Note Three** The general rate reduction would be calculated as follows:

| | |
|---|---|
| Taxable Income | $309,900 |
| Amount Eligible For The Small Business Deduction | ( 216,300) |
| Aggregate Investment Income (Note Two) | ( 93,600) |
| Full Rate Taxable Income | Nil |
| Rate | 13% |
| General Rate Reduction | Nil |

### *Part B - Refundable Part I Tax Payable*

The refundable portion of Part I Tax Payable would be the least of:

| | |
|---|---|
| • Amount Under ITA 129(4)(a)(i) [(30-2/3%)($93,600)] | $28,704 |
| • Amount Under ITA 129(4)(a)(ii) [(30-2/3%)($309,900 - $216,300)] | $28,704 |
| • Amount Under ITA 129(4)(a)(iii) Part I Tax Payable (Part A) | $55,659 |

The Part I refundable Tax Payable would be $28,704.

### Part C - Part IV Tax Payable

The required calculation of the Part IV Tax Payable is as follows:

| | |
|---|---|
| Part IV Tax On Portfolio Investments [($56,000)(38-1/3%)] | $21,467 |
| Part IV Tax On Subsidiary Dividends* | Nil |
| Total Part IV Tax | $21,467 |

*The subsidiary is a connected corporation. As it did not receive a dividend refund as a result of paying the dividends, Part IV tax is not applicable.

### Part D - GRIP Balance

Since Taxable Income is greater than Aggregate Investment Income, the December 31, 2019 GRIP balance would be calculated as follows:

| | | |
|---|---|---|
| GRIP Balance At End Of 2018 | | $ 59,000 |
| Taxable Income | $309,900 | |
| Income Eligible For SBD | ( 216,300) | |
| Aggregate Investment Income | ( 93,600) | |
| Adjusted Taxable Income | Nil | |
| Rate | 72% | Nil |
| Eligible Dividends Received | | 56,000 |
| Eligible Dividends Designated in 2018 | | Nil |
| GRIP Balance At End Of 2019 | | $115,000 |

### Part E - RDTOH Balances - December 31, 2019

As there was no December 31, 2018 balance in Vader's RDTOH, both the transitional eligible RDTOH and the transitional Non-Eligible RDTOH would be nil.

The December 31, 2019 balance in the Eligible RDTOH would be as follows:

| | |
|---|---|
| Transitional Balance | $ Nil |
| Part IV Tax On Portfolio Investments | 21,467 |
| Eligible RDTOH - December 31, 2019 | $21,467 |

The December 31, 2019 balance in the Non-Eligible RDTOH would be as follows:

| | |
|---|---|
| Transitional Balance | $ Nil |
| Part I Refundable Tax | 28,704 |
| Non-Eligible RDTOH - December 31, 2019 | $28,704 |

### Part F - Dividend Refunds

The corporation's GRIP balance at the end of 2019 is $115,000. As this is greater than the $32,400 of dividends paid in the year, all of these dividends can be designated as eligible.

The Eligible RDTOH of $21,467 is sufficient to support a full dividend refund on $56,000 ($21,467 ÷ 38-1/3%). This is also greater than the $32,400 of eligible dividends paid and means that the dividend refund on eligible dividends paid in 2019 would be equal to $12,420 [(38-1/3%)($32,400)].

No dividend refund would be claimed for 2019 on non-eligible dividends because no non-eligible dividends were paid in 2019.

### Part G - Total Federal Tax Payable

The required calculation to determine federal Tax Payable is as follows:

| | |
|---|---|
| Part I Tax (Part A) | $55,659 |
| Part IV Tax (Part C) | 21,467 |
| Dividend Refund (Part F) | ( 12,420) |
| Federal Tax Payable | $64,706 |

***Part H - RDTOH Balances - January 1, 2020***

The January 1, 2020 balance in the Eligible RDTOH would be as follows:

| | |
|---|---|
| Eligible RDTOH - December 31, 2019 | $21,467 |
| Dividend Refund On 2019 Eligible Dividends Paid | ( 12,420) |
| Eligible RDTOH - January 1, 2020 | $ 9,047 |

The January 1, 2020 balance in the Non-Eligible RDTOH would be as follows:

| | |
|---|---|
| Non-Eligible RDTOH - December 31, 2019 | $28,704 |
| Dividend Refund On 2019 Non-Eligible Dividends Paid | Nil |
| Non-Eligible RDTOH - January 1, 2020 | $28,704 |

## Self Study Solution Thirteen - 7

***Part A - Part I Tax Payable***

The Part I Tax Payable is calculated as follows:

| | |
|---|---|
| Base Amount Of Part I Tax [(38%)($503,500)] | $191,330 |
| Federal Tax Abatement [(10%)(72.95%)($503,500)] | ( 36,730) |
| Small Business Deduction [(19%)($200,000 Which Was Given)] | ( 38,000) |
| Additional Refundable Tax On Investment Income (Note One) | 11,781 |
| General Rate Reduction (Note Three) | ( 25,097) |
| Foreign Non-Business Income Tax Credit (Given) | ( 8,250) |
| Foreign Business Income Tax Credit (Given) | ( 34,300) |
| Part I Tax Payable | $ 60,734 |

**Note One** The aggregate investment income of $110,450 is calculated as follows:

| | |
|---|---|
| Interest On Loan To Subsidiary | $ 43,250 |
| Foreign Investment Income | 55,000 |
| Taxable Capital Gains | 24,500 |
| Net Capital Losses Claimed | ( 12,300) |
| Aggregate Investment Income (Note Two) | $110,450 |

The ITA 123.3 refundable tax (ART) is 10-2/3 percent of the lesser of:

| | | |
|---|---|---|
| 1. Aggregate Investment Income | | $110,450 |
| 2. Taxable Income | $503,500 | |
| Deduct: Amount Eligible For The SBD | ( 200,000) | $303,500 |

The ITA 123.3 tax on aggregate investment income is $11,781 [(10-2/3%)($110,450)].

**Note Two** The definition contained in ITA 129(4.1) excludes income from property that is incidental to carrying on an active business and, as a consequence, we have left out the $5,050 of term deposit interest. With respect to the interest on the loan to the subsidiary, if the subsidiary had deducted the $43,250 in computing active business income eligible

for the small business deduction, ITA 129(6) would have deemed this interest to be active business income rather than investment income. However, the problem notes that the subsidiary was not involved in the production of active business income and, as a consequence, the interest from the subsidiary is included in the above calculation of aggregate investment income.

**Note Three** The general rate reduction is based on the amount of Taxable Income that is not subject to other types of favourable tax treatment. The reduction would be calculated as follows:

| | |
|---|---|
| Taxable Income | $503,500 |
| Amount Eligible For The Small Business Deduction (Given) | ( 200,000) |
| Aggregate Investment Income (Note One) | ( 110,450) |
| Full Rate Taxable Income | $193,050 |
| Rate | 13% |
| General Rate Reduction | $ 25,097 |

### *Part B - Refundable Portion Of Part I Tax Payable*

The refundable portion of Part I tax would be the least of the following three amounts:

| | | |
|---|---|---|
| Aggregate Investment Income (See Note One) | | $110,450 |
| Rate | | 30-2/3% |
| Total | | $ 33,871 |
| Deduct Excess Of: | | |
| Foreign Non-Business Tax Credit | ($8,250) | |
| Over 8% Of Foreign Non-Business Income [(8%)($55,000)] | 4,400 | ( 3,850) |
| Amount Under ITA 129(4)(a)(i) | | $ 30,021 |

| | |
|---|---|
| Taxable Income | $503,500 |
| Deduct: | |
| Amount Eligible For The Small Business Deduction | ( 200,000) |
| [(100 ÷ 38-2/3)($8,250)] Foreign Non-Business Tax Credit | ( 21,336) |
| [(4)($34,300)] Foreign Business Tax Credit | ( 137,200) |
| Total | $144,964 |
| Rate | 30-2/3% |
| Amount Under ITA 129(4)(a)(ii) | $ 44,456 |

| | |
|---|---|
| Amount Under ITA 129(4)(a)(iii) = Part I Tax Payable (Part A) | $60,734 |

The least of these three amounts is $30,021, the amount calculated under ITA 129(4)(a)(i).

### *Part C - Part IV Tax Payable*

The Part IV Tax Payable would be calculated as follows:

| | |
|---|---|
| On Eligible Portfolio Dividends Received [(38-1/3%)($19,600)] | $ 7,513 |
| Share Of Dividend Refund Included In Non-Eligible Dividends From Subsidiary [(75%)($12,750)] | 9,563 |
| Part IV Tax Payable | $17,076 |

### Part D - GRIP Balance

Since Taxable Income is greater than Aggregate Investment Income, the December 31, 2019 GRIP balance would be calculated as follows:

| | | |
|---|---|---|
| GRIP Balance At End Of 2018 | | $ Nil |
| Taxable Income | $503,500 | |
| Income Eligible For SBD | ( 200,000) | |
| Aggregate Investment Income | ( 110,450) | |
| Adjusted Taxable Income | $193,050 | |
| Rate | 72% | 138,996 |
| Eligible Dividends Received | | 19,600 |
| Eligible Dividends Designated in 2018 | | Nil |
| GRIP Balance At End Of 2019 | | $158,596 |

### Part E - RDTOH Balances

The transitional balances for Sinzer would be based on the existing RDTOH of $13,900 ($23,500 - $9,600). As the corporation has no GRIP on December 31, 2018, none of this total will be allocated to its Eligible RDTOH, leaving the transitional balance in this account at nil. Given this, the transitional Non-Eligible RDTOH would be $13,900 ($13,900 - Nil).

The December 31, 2019 balance in the Eligible RDTOH would be as follows:

| | |
|---|---|
| Transitional Balance | $ Nil |
| Part IV Tax On Eligible Dividends - Portfolio Investments | 7,513 |
| Eligible RDTOH - December 31, 2019 | $7,513 |

The December 31, 2019 balance in the Non-Eligible RDTOH would be as follows:

| | |
|---|---|
| Transitional Balance | $13,900 |
| Part I Refundable Tax | 30,021 |
| Part IV Tax On Non-Eligible Subsidiary Dividends | 9,563 |
| Non-Eligible RDTOH - December 31, 2019 | $53,484 |

### Part F - Dividend Refund

Dividend refunds are calculated on the basis of dividends paid, not dividends declared. The relevant total here is $109,000 [$25,000 + (3)($28,000)].

As the corporation's GRIP balance is larger than this total, the corporation's policy would require that the full amount of the dividend be designated as eligible. The Eligible RDTOH of $7,513 is sufficient to support a full dividend refund on $19,600 ($7,513 ÷ 38-1/3%). If $109,000 of dividends paid are designated eligible, the refund on these eligible dividends would be $7,513, the lesser of:

- $41,783 [(38-1/3%)($109,000)]; and
- $7,513, the balance in the Eligible RDTOH.

The Non-Eligible RDTOH of $53,484 is sufficient to support a full dividend refund on $139,523 ($53,484 ÷ 38-1/3%). If all of the dividends paid are designated eligible, no dividend refund could be claimed on non-eligible dividends because no non-eligible dividends were paid in 2019.

### *Part G - Total Federal Tax Payable*

The required calculation to determine federal Tax Payable is as follows:

| | |
|---|---|
| Part I Tax (Part A) | $60,734 |
| Part IV Tax (Part C) | 17,076 |
| Dividend Refund (Part F) | ( 7,513) |
| Federal Tax Payable | $70,297 |

### *Part H - Advice On Dividend Policy*

The change in tax rules for years after 2018 affects the dividend refund available on the payment of eligible dividends. Sinzer's dividend policy to maximize eligible dividends, which was beneficial to you personally before 2019, now limits the dividend refund that can be claimed by your corporation. I suggest you change the policy to paying the maximum amount of eligible dividends on which a dividend refund would be available. That will increase the taxes paid by you personally on the total dividends received, but will give you an increase in the dividend refund at the corporate level.

The Eligible RDTOH of $7,513 would all be refunded on the payment of $19,600 in eligible dividends [(38-1/3%)($19,600) = $7,513]. This is equal to the eligible dividends received during 2019. The remaining $89,400 would be non-eligible dividends which would enable Sinzer to claim a dividend refund of $34,270 [(38-1/3%)($89,400)] because it is less than the balance in the Non-Eligible RDTOH.

The increase in the personal tax rate going from eligible to non-eligible dividends is about 8 percentage points on average. Using that estimate means that it will cost you personally $7,152 [(8%)($89,400)] in taxes to receive a dividend refund of $34,270 in your corporation. As you are the sole shareholder, you will benefit from the dividend refund.

## Self Study Solution Thirteen - 8

### *Part A - Net And Taxable Income*

The calculation of Acme Imports' Net Income For Tax Purposes and Taxable Income would be as follows:

| | | |
|---|---|---|
| Accounting Income Before Taxes | | $232,300 |
| Additions: | | |
| Amortization Expense | $29,500 | |
| Charitable Donations | 25,000 | |
| Taxable Capital Gain On Sale Of Equipment [(1/2)($84,500 - $62,000)] | 11,250 | |
| Golf Club Membership | 2,800 | |
| 50 Percent Of Business Meals And Entertainment | 3,360 | |
| Share Issue Costs [(80%)($950)] | 760 | |
| Costs Of Supplementary Letters Patent | 7,000 | |
| Interest On Mortgage For The Land | 12,300 | 91,970 |
| Deductions: | | |
| CCA (Note One) | ($53,050) | |
| Gain On Sale Of Equipment ($84,500 - $27,500) | ( 57,000) | ( 110,050) |
| **Net Income For Tax Purposes** | | **$214,220** |
| Charitable Donations | | ( 25,000) |
| Dividends From Sarco Ltd. | | ( 24,000) |
| **Taxable Income** | | **$165,220** |

**Note One** The maximum CCA on the Class 8 equipment would be calculated as follows:

| | | |
|---|---|---|
| Opening UCC | | $256,000 |
| Disposition - Lesser Of: | | |
| Proceeds Of Disposition = $84,500 | | |
| Capital Cost = $62,000 | | ( 62,000) |
| CCA Base | | $194,000 |
| Rate | | 20% |
| CCA - Class 8 | | $ 38,800 |

The customer list, as well as the cost of the supplementary letters patent would be added to Class 14.1. The maximum CCA for this Class would be as follows:

| | |
|---|---|
| Opening UCC | Nil |
| Additions ($183,000 + $7,000) | $190,000 |
| AccII Adjustment [(1/2)($190,000)] | 95,000 |
| CCA Base | $285,000 |
| Rate | 5% |
| CCA - Class 14.1 | $ 14,250 |

Base on this, the maximum total CCA would be $53,050 ($38,800 + $14,250).

Several of the items in this problem need further comment. These are as follows:

- **Item 4** With respect to the costs of issuing shares, such amounts have to be deducted over at least 5 years at a maximum rate of 20 percent per year.
- **Item 6** Only 50 percent of the $6,720 in charges at the local golf and country club are deductible.
- **Item 7** The cars provided to the principal shareholder and to the manager of the Company will result in their being assessed for a substantial taxable benefit. However, the costs are fully deductible to the Company.
- **Item 10** The fees paid to the site consultant are deductible as indicated in ITA 20(1)(dd). ITA 18(3.1) disallows the deduction of interest on financing related to land during construction. The $12,300 interest on the $244,000 mortgage on the land would be capitalized and is not deductible.

### *Part B - Active Business Income*

The active business income of Acme is as follows:

| | | |
|---|---|---|
| Net Income For Tax Purposes | | $214,220 |
| Dividends | | ( 24,000) |
| Aggregate Investment Income: | | |
| Interest Revenue | ($10,000) | |
| Taxable Capital Gain | ( 11,250) | ( 21,250) |
| Active Business Income | | $168,970 |

***Part C - Federal Tax Payable***

The calculation of Acme Ltd.'s federal Tax Payable would be as follows:

| | |
|---|---|
| Base Amount Of Part I Tax [(38%)($165,220)] | $ 62,784 |
| Federal Tax Abatement [(10%)($165,220)] | ( 16,522) |
| Small Business Deduction (Note Two) | ( 31,392) |
| Additional Refundable Tax On Investment Income (Note Three) | Nil |
| General Rate Reduction (Note Four) | Nil |
| Part I Tax Payable | $ 14,870 |
| Part IV Tax Payable (Note Five) | 3,000 |
| Dividend Refund (No Dividends Declared) | Nil |
| Federal Tax Payable | $ 17,870 |

**Note Two** As Acme and Sarco's combined ADJUSTED Aggregate Investment Income exceeds $50,000, there will be a grind of the annual business limit. The amount of the grind is as follows:

[($500,000/$500,000)][(5)($110,000 - $50,000)] = $300,000

Applying this grind, the small business deduction is 19 percent of the least of the following three amounts:

| | |
|---|---|
| 1. Active Business Income (Part B) | $168,970 |
| 2. Taxable Income (no foreign tax credit adjustment) | $165,220 |
| 3. Reduced Annual Business Limit ($500,000 - $300,000) | $200,000 |

This gives a small business deduction of $31,392 [(19%)($165,220)].

**Note Three** The ITA 123.3 refundable tax (ART) is 10-2/3 percent of the lesser of:

| | | |
|---|---|---|
| 1. Aggregate Investment Income (Part B) | | $21,250 |
| 2. Taxable Income | $165,220 | |
| Deduct: Amount Eligible For The SBD | ( 165,220) | Nil |

Since the income eligible for the small business deduction is equal to Taxable Income, there is no ITA 123.3 tax on investment income payable.

**Note Four** The general rate reduction would be nil, calculated as follows:

| | |
|---|---|
| Taxable Income | $165,220 |
| Amount Eligible For The Small Business Deduction | ( 165,220) |
| Aggregate Investment Income (Part B) | ( 21,250) |
| Full Rate Taxable Income | Nil |
| Rate | 13% |
| General Rate Reduction | Nil |

**Note Five** The Part IV Tax on Sarco's non-eligible dividend would be as follows:

| | |
|---|---|
| Sarco's Dividend Refund | $5,000 |
| Acme's Ownership Percentage | 60% |
| Acme's Share Of Refund = Part IV Tax Payable | $3,000 |

***Part D - RDTOH Balances***

The amount of refundable Part I tax will be the least of the following three amounts. In this problem, the calculation of these amounts is greatly simplified by the absence of foreign non-business income. The calculations are as follows:

**ITA 129(4)(a)(i)** $6,517 - This amount would be 30-2/3 percent of Aggregate Investment Income of $21,250 ($10,000 + $11,250).

**ITA 129(4)(a)(ii)** Nil - This amount would be 30-2/3 percent of Taxable Income, reduced by the amount of income that is eligible for the small business deduction [(30-2/3%)($165,220 - $165,220)].

**ITA 129(4)(a)(iii)** $14,870 - This amount would be the Part I Tax Payable.

The least of these amounts is nil, so there would be no refundable portion of Part I tax.

As Acme's RDTOH on December 31, 2018 was nil, both the transitional Eligible RDTOH and the transitional Non-Eligible RDTOH would be nil. As there is no addition to the Eligible RDTOH for the year, the December 31, 2019 balance in the Eligible RDTOH would be nil.

The December 31, 2019 balance in the Non-Eligible RDTOH would be as follows:

| | |
|---|---|
| Transitional Non-Eligible RDTOH | $ Nil |
| Part IV Tax Payable On Sarco's Non-Eligible Dividend | 3,000 |
| Non-Eligible RDTOH - December 31, 2019 | $3,000 |

The December 31, 2019 GRIP would be as follows:

| | | |
|---|---|---|
| GRIP Balance At End Of 2018 | | Nil |
| Taxable Income | $165,220 | |
| Income Eligible For SBD | ( 165,220) | |
| Aggregate Investment Income | ( 21,250) | |
| Adjusted Taxable Income | $ Nil | |
| Rate | 72% | Nil |
| Eligible Dividends Received | | Nil |
| Eligible Dividends Designated in 2018 | | Nil |
| GRIP Balance At End Of 2019 | | Nil |

### *Part A - Net And Taxable Income*

The calculation of Acme Imports' Net Income For Tax Purposes and Taxable Income would be as follows:

| | | |
|---|---|---|
| Accounting Income Before Taxes | | $232,300 |
| Additions: | | |
| Amortization Expense | $29,500 | |
| Charitable Donations | 25,000 | |
| Taxable Capital Gain On Sale Of Equipment [(1/2)($84,500 - $62,000)] | 11,250 | |
| Golf Club Membership | 2,800 | |
| 50 Percent Of Business Meals And Entertainment | 3,360 | |
| Share Issue Costs [(80%)($950)] | 760 | |
| Costs Of Supplementary Letters Patent | 7,000 | |
| Interest On Mortgage For The Land | 12,300 | 91,970 |
| Deductions: | | |
| CCA (Note One) | ($53,050) | |
| Gain On Sale Of Equipment ($84,500 - $27,500) | ( 57,000) | ( 110,050) |
| **Net Income For Tax Purposes** | | **$214,220** |
| Charitable Donations | | ( 25,000) |
| Dividends From Sarco Ltd. | | ( 24,000) |
| **Taxable Income** | | **$165,220** |

**Note One** The maximum CCA on the Class 8 equipment would be calculated as follows:

| | |
|---|---|
| Opening UCC | $256,000 |
| Disposition - Lesser Of: | |
| Proceeds Of Disposition = $84,500 | |
| Capital Cost = $62,000 | ( 62,000) |
| CCA Base | $194,000 |
| Rate | 20% |
| CCA - Class 8 | $ 38,800 |

The customer list, as well as the cost of the supplementary letters patent would be added to Class 14.1. The maximum CCA for this Class would be as follows:

| | |
|---|---|
| Opening UCC | Nil |
| Additions ($183,000 + $7,000) | $190,000 |
| AccII Adjustment [(1/2)($190,000)] | 95,000 |
| CCA Base | $285,000 |
| Rate | 5% |
| CCA - Class 14.1 | $ 14,250 |

Base on this, the maximum total CCA would be $53,050 ($38,800 + $14,250).

Several of the items in this problem need further comment. These are as follows:

- **Item 4** With respect to the costs of issuing shares, such amounts have to be deducted over at least 5 years at a maximum rate of 20 percent per year.
- **Item 6** Only 50 percent of the $6,720 in charges at the local golf and country club are deductible.
- **Item 7** The cars provided to the principal shareholder and to the manager of the Company will result in their being assessed for a substantial taxable benefit. However, the costs are fully deductible to the Company.
- **Item 10** The fees paid to the site consultant are deductible as indicated in ITA 20(1)(dd). ITA 18(3.1) disallows the deduction of interest on financing related to land during construction. The $12,300 interest on the $244,000 mortgage on the land would be capitalized and is not deductible.

### *Part B - Active Business Income*

The active business income of Acme is as follows:

| | | |
|---|---|---|
| Net Income For Tax Purposes | | $214,220 |
| Dividends | | ( 24,000) |
| Aggregate Investment Income: | | |
| Interest Revenue | ($10,000) | |
| Taxable Capital Gain | ( 11,250) | ( 21,250) |
| Active Business Income | | $168,970 |

### Part C - Federal Tax Payable

The calculation of Acme Ltd.'s federal Tax Payable would be as follows:

| | |
|---|---|
| Base Amount Of Part I Tax [(38%)($165,220)] | $ 62,784 |
| Federal Tax Abatement [(10%)($165,220)] | ( 16,522) |
| Small Business Deduction (Note Two) | ( 31,392) |
| Additional Refundable Tax On Investment Income (Note Three) | Nil |
| General Rate Reduction (Note Four) | Nil |
| Part I Tax Payable | $ 14,870 |
| Part IV Tax Payable (Note Five) | 3,000 |
| Dividend Refund (No Dividends Declared) | Nil |
| Federal Tax Payable | $ 17,870 |

**Note Two** As Acme and Sarco's combined ADJUSTED Aggregate Investment Income exceeds $50,000, there will be a grind of the annual business limit. The amount of the grind is as follows:

[($500,000/$500,000)][(5)($110,000 - $50,000)] = $300,000

Applying this grind, the small business deduction is 19 percent of the least of the following three amounts:

| | |
|---|---|
| 1. Active Business Income (Part B) | $168,970 |
| 2. Taxable Income (no foreign tax credit adjustment) | $165,220 |
| 3. Reduced Annual Business Limit ($500,000 - $300,000) | $200,000 |

This gives a small business deduction of $31,392 [(19%)($165,220)].

**Note Three** The ITA 123.3 refundable tax (ART) is 10-2/3 percent of the lesser of:

| | | |
|---|---|---|
| 1. Aggregate Investment Income (Part B) | | $21,250 |
| 2. Taxable Income | $165,220 | |
| Deduct: Amount Eligible For The SBD | ( 165,220) | Nil |

Since the income eligible for the small business deduction is equal to Taxable Income, there is no ITA 123.3 tax on investment income payable.

**Note Four** The general rate reduction would be nil, calculated as follows:

| | |
|---|---|
| Taxable Income | $165,220 |
| Amount Eligible For The Small Business Deduction | ( 165,220) |
| Aggregate Investment Income (Part B) | ( 21,250) |
| Full Rate Taxable Income | Nil |
| Rate | 13% |
| General Rate Reduction | Nil |

**Note Five** The Part IV Tax on Sarco's non-eligible dividend would be as follows:

| | |
|---|---|
| Sarco's Dividend Refund | $5,000 |
| Acme's Ownership Percentage | 60% |
| Acme's Share Of Refund = Part IV Tax Payable | $3,000 |

### Part D - RDTOH Balances

The amount of refundable Part I tax will be the least of the following three amounts. In this problem, the calculation of these amounts is greatly simplified by the absence of foreign non-business income. The calculations are as follows:

**ITA 129(4)(a)(i)** $6,517 - This amount would be 30-2/3 percent of Aggregate Investment Income of $21,250 ($10,000 + $11,250).

**ITA 129(4)(a)(ii)** Nil - This amount would be 30-2/3 percent of Taxable Income, reduced by the amount of income that is eligible for the small business deduction [(30-2/3%)($165,220 - $165,220)].

**ITA 129(4)(a)(iii)** $14,870 - This amount would be the Part I Tax Payable.

The least of these amounts is nil, so there would be no refundable portion of Part I tax.

As Acme's RDTOH on December 31, 2018 was nil, both the transitional Eligible RDTOH and the transitional Non-Eligible RDTOH would be nil. As there is no addition to the Eligible RDTOH for the year, the December 31, 2019 balance in the Eligible RDTOH would be nil.

The December 31, 2019 balance in the Non-Eligible RDTOH would be as follows:

| | |
|---|---|
| Transitional Non-Eligible RDTOH | $ Nil |
| Part IV Tax Payable On Sarco's Non-Eligible Dividend | 3,000 |
| Non-Eligible RDTOH - December 31, 2019 | $3,000 |

The December 31, 2019 GRIP would be as follows:

| | | |
|---|---|---|
| GRIP Balance At End Of 2018 | | Nil |
| Taxable Income | $165,220 | |
| Income Eligible For SBD | ( 165,220) | |
| Aggregate Investment Income | ( 21,250) | |
| Adjusted Taxable Income | $ Nil | |
| Rate | 72% | Nil |
| Eligible Dividends Received | | Nil |
| Eligible Dividends Designated in 2018 | | Nil |
| GRIP Balance At End Of 2019 | | Nil |

## Self Study Solution Thirteen - 9

### *Part A - Net And Taxable Income*

Brasco's minimum Net Income For Tax Purposes and Taxable Income would be calculated as follows:

| | | |
|---|---|---|
| Active Business Income (Given) | | $171,000 |
| Net Taxable Capital Gains (Given) | | 36,000 |
| Canadian Source Interest Income | | 2,200 |
| Eligible Portfolio Dividends | | 15,800 |
| Foreign Source Investment Income (Gross Amount) | | 4,500 |
| Non-Eligible Dividends From Subsidiary | | 37,800 |
| **Net Income For Tax Purposes** | | **$267,300** |
| Dividends Received: | | |
| Portfolio | ($15,800) | |
| Subsidiary | ( 37,800) | ( 53,600) |
| Charitable Donations | | ( 11,900) |
| Non-Capital Loss Carry Forward Deducted | | ( 25,800) |
| Net Capital Loss Carry Forward Deducted (Note One) | | ( 36,000) |
| **Taxable Income** | | **$140,000** |

**Note One** Note that the net capital loss carry forward is limited to the taxable capital gains. This will leave a net capital loss carry forward of $28,500 ($64,500 - $36,000) for subsequent periods.

### *Part B - Part I Tax Payable (FTC = Amount Withheld)*

Assuming the foreign non-business tax credit is equal to the amount withheld, Brasco's Tax Payable would be calculated as follows:

| | |
|---|---|
| Base Amount Of Part I Tax [(38%)($140,000)] | $53,200 |
| Federal Tax Abatement [(10%)($140,000)] | ( 14,000) |
| Small Business Deduction (Note Two) | ( 23,750) |
| Additional Refundable Tax On Investment Income (Note Three) | 715 |
| General Rate Reduction (Note Four) | ( 1,079) |
| Foreign Non-Business Tax Credit (Given As Amount Withheld) | ( 675) |
| Part I Tax Payable | $14,411 |

**Note Two** The small business deduction is 19 percent of the least of the following three amounts:

| | | | |
|---|---|---|---|
| 1. | Active Business Income (Given) | | $171,000 |
| 2. | Taxable Income | $140,000 | |
| | Deduct: | | |
| | [(100/28)($675)] Foreign Non-Business Tax Credit | ( 2,411) | $137,589 |
| 3. | Allocated Annual Business Limit (Given) | | $125,000 |

The lowest of these figures is the allocated annual limit of $125,000 and this gives a small business deduction of $23,750 [(19%)($125,000)].

**Note Three** The aggregate investment income of $6,700 is calculated as follows:

| | |
|---|---|
| Taxable Capital Gains | $36,000 |
| Net Capital Loss Carry Forward Deducted | ( 36,000) |
| Canadian Interest | 2,200 |
| Foreign Investment Income | 4,500 |
| Aggregate Investment Income | $ 6,700 |

The ITA 123.3 refundable tax (ART) is 10-2/3 percent of the lesser of:

| | | | |
|---|---|---|---|
| 1. | Aggregate Investment Income | | $ 6,700 |
| 2. | Taxable Income | $140,000 | |
| | Deduct: Amount Eligible For The SBD | ( 125,000) | $15,000 |

The ITA 123.3 tax on aggregate investment income is $715 [(10-2/3%)($6,700)].

**Note Four** The general rate reduction is based on the amount of Taxable Income that is not subject to other types of favourable tax treatment. The reduction would be calculated as follows:

| | |
|---|---|
| Taxable Income | $140,000 |
| Amount Eligible For The Small Business Deduction (Note Two) | ( 125,000) |
| Aggregate Investment Income (Note Three) | ( 6,700) |
| Full Rate Taxable Income | $ 8,300 |
| Rate | 13% |
| General Rate Reduction | $ 1,079 |

### *Part C - Refundable Part I Tax Payable*

The refundable portion of Part I tax will be the least of the following three amounts:

| | | |
|---|---|---|
| Aggregate Investment Income (Note Three) | | $ 6,700 |
| Rate | | 30-2/3% |
| | | $ 2,055 |
| Deduct Excess Of: | | |
| Foreign Non-Business Tax Credit | ($675) | |
| Over 8% Of Foreign Non-Business Income [(8%)($4,500)] | 360 | ( 315) |
| Amount Under ITA 129(4)(a)(i) | | $ 1,740 |

| | |
|---|---|
| Taxable Income | $140,000 |
| Deduct: | |
| Amount Eligible For The Small Business Deduction | ( 125,000) |
| [(100 ÷ 38-2/3)($675)] Foreign Non-Business Tax Credit | ( 1,746) |
| Adjusted Taxable Income | $ 13,254 |
| Rate | 30-2/3% |
| Amount Under ITA 129(4)(a)(ii) | $ 4,065 |

| | |
|---|---|
| Amount Under ITA 129(4)(a)(iii) = Part I Tax Payable | $14,411 |

The least of these three amounts would be $1,740, the amount calculated under ITA 129(4)(a)(i).

### *Part D - Part IV Tax Payable*

The calculation of Part IV Tax Payable would be as follows:

| | |
|---|---|
| Part IV Tax On Masco's Non-Eligible Dividends [(60%)($24,1520)] | $14,490 |
| Part IV Tax On Eligible Dividends From Portfolio Investments [(38-1/3%)($15,800)] | 6,057 |
| Part IV Tax Payable | $20,547 |

### *Part E - GRIP Balance*

The 2019 ending balance in GRIP will be calculated as follows:

| | | |
|---|---|---|
| GRIP Balance At End Of 2018 | | $126,000 |
| Taxable Income | $140,000 | |
| Income Eligible For SBD | ( 125,000) | |
| Aggregate Investment Income | ( 6,700) | |
| Adjusted Taxable Income | $ 8,300 | |
| Rate | 72% | 5,976 |
| Eligible Dividends Received | | 15,800 |
| Eligible Dividends Designated in 2018 | | Nil |
| GRIP Balance At End Of 2019 | | $147,776 |

Any eligible dividends paid during 2019 will be deducted from the GRIP in 2020.

### Part F - RDTOH Balances

The January 1, 2019 GRIP balance is $126,000 ($126,000 - Nil).

The base for the transitional RDTOH balances is the $7,000 balance in Brasco's RDTOH on December 31, 2018 (no dividends were paid in 2018). The transitional Eligible RDTOH will be the lesser of:

- The $7,000 RDTOH balance; and
- $48,300 [(38-1/3%)($126,000)].

The lesser figure is $7,000 and this will be the transitional Eligible RDTOH. This allocation will leave the transitional Non-Eligible RDTOH equal to nil ($7,000 - $7,000).

Based on this, the December 31, 2019 RDTOH balances would be as follows:

| | |
|---|---:|
| Transitional Balance | $ 7,000 |
| Part IV Tax On Eligible Dividends - Portfolio Investments | 6,057 |
| Eligible RDTOH - December 31, 2019 | $13,057 |

The December 31, 2019 balance in the Non-Eligible RDTOH would be as follows:

| | |
|---|---:|
| Transitional Balance | $ Nil |
| Part I Refundable Tax | 1,740 |
| Part IV Tax On Masco's Non-Eligible Dividends | 14,490 |
| Non-Eligible RDTOH - December 31, 2019 | $16,230 |

### Part G - Dividend Refund

Brasco paid $39,000 in dividends, creating a potential refund of $14,950 [(38-1/3%)($39,000)]. Given Brasco's GRIP balance of $147,776, the entire $39,000 dividend could be designated as eligible. However, the Eligible RDTOH balance is only $13,057. Given this, the maximum designation on which a full refund would be available would be $34,062 ($13,057 ÷ 38-1/3%).

If $34,062 of the dividends paid are designated eligible, the dividend refund on these eligible dividends would be $13,057, the lesser of:

- $13,057 [(38-1/3%)($34,062)]; and
- $13,057, the balance in the Eligible RDTOH.

This would leave $4,938 ($39,000 - $34,062) as non-eligible dividends. The dividend refund on these non-eligible dividends would be $1,893, the lesser of:

- $1,893 [(38-1/3%)($4,938)]; and
- $16,230, the balance in the Non-Eligible RDTOH.

Based on this, the total dividend refund would be as follows:

| | |
|---|---:|
| Dividend Refund On Eligible Dividends | $13,057 |
| Dividend Refund On Non-Eligible Dividends | 1,893 |
| Total Dividend Refund | $14,950 |

### Part H - Foreign Tax Credit

If you cannot assume that the foreign tax credit is equal to the amount withheld, the actual foreign tax credit is a complex calculation in this situation. The use of foreign taxes paid as credits against Canadian Tax Payable is limited by a formula that includes the "tax otherwise payable". In the case of foreign taxes paid on non-business income, the "tax otherwise payable" in the formula includes the ART that is assessed under ITA 123.3 and the general rate reduction. This creates a problem in that the calculation of the ART and the general rate reduction include the amount eligible for the small business deduction [ITA 123.3(b)]. In

turn, the determination of the amount eligible for the small business deduction requires the use of the foreign tax credits for foreign taxes paid on non-business and business income [ITA 125(1)(b)(i) and (ii)].

To solve this circular calculation, for the purpose of calculating the small business deduction, the foreign tax credit for taxes paid on non-business income is calculated using a "tax otherwise payable" figure that does not include the ART under ITA 123.3 or the general rate reduction. This means that in situations where foreign non-business income, the small business deduction, and the ART are involved, the following procedures should be used:

1. Calculate the foreign non-business tax credit using a "tax otherwise payable" that excludes both the ART and the general rate reduction. This initial version of the foreign non-business tax credit will be used only for determining the small business deduction, with the actual credit available calculated after the ART and the general rate reduction have been determined.
2. Calculate the amount eligible for the small business deduction using the number determined in step 1.
3. Calculate the ART and the general rate reduction using the amount eligible for the small business deduction determined in step 2.
4. Calculate the actual foreign non-business tax credit using a "tax otherwise payable" figure that includes the ART and the general rate reduction.

The initial version of the foreign non-business tax credit (Step 1) will be the lesser of the actual tax paid of $675, and an amount determined by the following formula:

$$\left(\frac{\text{Foreign Non - Business Income}}{\text{Adjusted Net Income}}\right)(\text{Part I Tax Otherwise Payable Excluding The ART And GRR})$$

$$= \left(\frac{\$4,500}{\$267,300 - \$53,600 - \$36,000}\right)(\$53,200 - \$14,000)$$

$$= \$993$$

Part I tax otherwise payable in the preceding formula does not include the ART under ITA 123.3 or the general rate reduction. Adjusted Net Income in the formula is Net Income For Tax Purposes minus deductible dividends and the net capital loss carry forward claimed in the current year. In this case, the actual tax paid of $675 will be the credit. This means that the previously calculated small business deduction will be unchanged (Note 2, Step 2) and, in turn, the ART (Note 3, Step 3) and general rate reduction (Note 4, Step 3) will be unchanged.

We can now calculate the actual foreign non-business tax credit which takes into consideration the ART and the general rate reduction (Step 4). It is the lesser of the actual taxes paid of $675 and an amount determined by the following formula:

$$\left(\frac{\text{Foreign Non - Business Income}}{\text{Adjusted Net Income}}\right)(\text{Part I Tax Otherwise Payable Including The ART And GRR})$$

$$= \left(\frac{\$4,500}{\$267,300 - \$53,600 - \$36,000}\right)(\$53,200 - \$14,000 + \$715 - \$1,079)$$

$$= \$983$$

In this calculation, the actual taxes paid of $675 will again be the credit.

## Chapter 13 Learning Objectives

After completing Chapter 13, you should be able to:

1. Explain the goal of integration in the design of the Canadian corporate tax system (paragraph [P hereafter] 13-1 to 13-5).
2. Calculate after-tax income retained from eligible and non-eligible dividends received (P 13-6 to 13-14).
3. Demonstrate how the dividend gross up and tax credit procedures work to implement integration with respect to business income (P 13-15 to 13-22).
4. List the components of aggregate investment income as it is defined in ITA 129(4) and describe the basic concept of refundable taxes (P 13-23 to 13-38).
5. Calculate the additional refundable tax (ART) on the investment income of a CCPC (P 13-39 to 13-47).

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6. Calculate the Part I refundable tax on the investment income of a CCPC (P 13-48 to 13-66).
7. Apply the provisions related to the Part IV refundable tax on private corporations, including those related to dividends from a connected corporation (P 13-67 to 13-94).
8. Explain and apply the eligible dividend designation calculations relevant to CCPCs and their GRIP (P 13-95 to 13-104).
9. Explain and apply the eligible dividend designation calculations relevant to non-CCPCs and their LRIP (P 13-105 to 13-108).
10. Describe and calculate the Part III.1 tax on excessive eligible dividend designations (EEDD) (P 13-109 to 13-117).

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11. Apply the transitional provision to the balance in the Refundable Dividend Tax On Hand (RDTOH) account (P 13-118 to 13-130).
12. Calculate the Part I refundable tax (P 13-131 to 13-143).
13. Calculate the balance in the Eligible and Non-Eligible (RDTOH) accounts (P 13-144 to 13-152).
14. Calculate the dividend refund on the payment of eligible and non-eligible dividends (P 13-153 to 13-156).

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15. Describe the economic impact of the change in RDTOH rules (P 13-157 to 13-174).
16. Use a logical approach to deal with comprehensive calculations of corporate Taxable Income and Tax Payable (P 13-175 to 13-176).
17. Review a simple corporate tax return completed using the ProFile T2 tax preparation software program.

# CHAPTER 14

## How To Work Through Chapter 14

We recommend the following approach in dealing with the material in this chapter:

### Acquisition Of Control Rules, Including Effect On Loss Carry Forwards

- Read paragraph 14-1 to 14-21 (in the textbook).
- Do Exercise Fourteen-1 (in the textbook) and check the solution in this Study Guide.
- Read paragraph 14-22 to 14-24.
- Do Exercise Fourteen-2 and check the solution in this Study Guide.
- Read paragraph 14-25 to 14-34.
- Do Exercise Fourteen-3 and check the solution in this Study Guide.
- Do Self Study Problems Fourteen-1 and Fourteen-2 which are available on MyLab and check the solutions in this Study Guide.

### Associated Companies

- Read paragraph 14-35 to 14-52.
- Do Exercise Fourteen-4 and check the solution in this Study Guide.
- Do Self Study Problems Fourteen-3 and Fourteen-4 and check the solutions in this Study Guide.

### Investment Tax Credits And SR & ED Expenditures By CCPCs

- Read paragraph 14-53 to 14-62.
- Do Exercise Fourteen-5 and check the solution in this Study Guide.
- Read paragraph 14-63 to 14-65.
- Do Exercise Fourteen-6 and check the solution in this Study Guide.

### Refundable Investment Tax Credits

- Read paragraph 14-66 to 14-71.
- Do Exercise Fourteen-7 and check the solution in this Study Guide.
- Do Self Study Problem Fourteen-5 and check the solution in this Study Guide.
- Read paragraph 14-72 to 14-75.

### Shareholders' Equity Under GAAP

- Read paragraph 14-76 to 14-78.

### Paid Up Capital

- Read paragraph 14-79 to 14-82.
- Do Exercise Fourteen-8 and check the solution in this Study Guide.

### Tax Basis Retained Earnings

- Read paragraph 14-83 to 14-91.

### Capital Dividend Account

- Read paragraph 14-92 to 14-95.
- Do Exercise Fourteen-9 and check the solution in this Study Guide.
- Do Self Study Problem Fourteen-6 and Fourteen-7 and check the solutions in this Study Guide.

### Distributions Of Corporate Surplus Through Cash, Stock And In Kind Dividends

- Read paragraph 14-96 to 14-107.
- Do Exercise Fourteen-10 and check the solution in this Study Guide.
- Read paragraph 14-108 to 14-110.
- Do Exercise Fourteen-11 and check the solution in this Study Guide.

### Capital Dividends

- Read paragraph 14-111 to 14-115.

### ITA 84(1) Deemed Dividends - Increase In PUC

- Read paragraph 14-116 to 14-120.
- Do Exercise Fourteen-12 and check the solution in this Study Guide.
- Read paragraph 14-121.

### ITA 84(2) Deemed Dividends - On Winding-Up

- Read paragraph 14-122 to 14-126.
- Do Exercise Fourteen-13 and check the solution in this Study Guide.

### ITA 84(3) Deemed Dividends - Redemption, Acquisition, Or Cancellation Of Shares

- Read paragraph 14-127 to 14-130.
- Do Exercise Fourteen-14 and check the solution in this Study Guide.

### ITA 84(4) And ITA 84(4.1) Deemed Dividends

- Read paragraph 14-131 to 14-136.
- Do Exercise Fourteen-15 and check the solution in this Study Guide.
- Do Self Study Problem Fourteen-8 and check the solution in this Study Guide.

### To Complete This Chapter

- If you would like more practice in problem solving, do the Supplementary Self Study Problems for the chapter. These problems and solutions are available on MyLab.
- Review the Key Terms Used In This Chapter in the textbook at the end of Chapter 14. Consult the Glossary for the meaning of any key terms you do not know.
- Test yourself with the Chapter 14 Glossary Flashcards available on MyLab.
- Ensure you have achieved the Chapter 14 Learning Objectives listed in this Study Guide.
- As a review, we recommend you view the PowerPoint presentation for Chapter 14 that is on MyLab.

### Practice Examination

- Write the Practice Examination for Chapter 14 that is on MyLab. Mark your examination using the Practice Examination Solution that is on MyLab.

## Solutions to Chapter Fourteen Exercises

### *Exercise Fourteen - 1 Solution*

**No Acquisition Of Control** Net Income For Tax Purposes for 2019 is $289,000 ($42,000 + $247,000) and, if there was no acquisition of control, the total $135,000 non-capital loss carry forward could be deducted. This would result in a 2019 Taxable Income of $154,000 ($289,000 - $135,000).

**Acquisition Of Control** If there was an acquisition of the control on January 1, 2019, Net Income For Tax Purposes would still be $289,000. However, in this case, the non-capital loss carry forward could only be used to the extent of the pen business income of $42,000. This means that Taxable Income would be $247,000 ($289,000 - $42,000) with a non-capital loss carry forward of $93,000 ($135,000 - $42,000).

### *Exercise Fourteen - 2 Solution*

The tax consequences of the acquisition of control procedures are as follows:

**Land** As the fair market of the land is less than its adjusted cost base, ITA 111(4)(c) will require that it be written down to its fair market value of $215,000. This will result in an allowable capital loss of $39,000 [($293,000 - $215,000) ÷ 2].

**Class 8 Assets** As the fair market value of this property is less than its UCC, ITA 111(5.1) requires that it be written down to its fair market value. The $92,000 ($276,000 - $184,000) write-down will be treated as CCA to be deducted in the deemed taxation year. For capital gains purposes, the property will retain its original capital cost of $416,000.

### *Exercise Fourteen - 3 Solution*

It would clearly be desirable to elect to have a deemed disposition of the non-depreciable assets. This could be achieved by electing to have a deemed disposition of the non-depreciable assets for $650,000. This would result in a $75,000 taxable capital gain [(1/2)($650,000 - $500,000)] on the deemed disposition. This will leave $35,000 ($110,000 - $75,000) of the net capital loss carry forward.

This $35,000 could be eliminated by electing to have a deemed disposition of the depreciable property at an elected value of $470,000. This election would produce the required taxable capital gain of $35,000 [(1/2)($470,000 - $400,000)].

The election would also produce recapture of $50,000 ($400,000 - $350,000). As this is $5,000 ($50,000 - $45,000) greater than the operating loss, this would result in Taxable Income and Tax Payable. However, the ability to use the remaining $35,000 net capital loss carry forward is probably worth the cost of the Tax Payable on the extra $5,000 of income. In addition, the election would result in increased future CCA based on a new capital cost, for CCA purposes only, of $435,000 [$400,000 + (1/2)($470,000 - $400,000)].

### *Exercise Fourteen - 4 Solution*

**Top And Middle** Top and Middle are associated under ITA 256(1)(a) as Top controls Middle.

**Top And Bottom** Top and Bottom are associated under ITA 256(1)(b) as they are both controlled by the same person, Mr. Top. He controls Top directly. In addition, he controls Bottom through a combination of direct ownership, indirect ownership, and deemed ownership. His majority interest would be calculated as follows:

| | |
|---|---:|
| Direct Interest in Bottom | 5% |
| Indirect Interest Through Top Company [(100%)(10%)] | 10% |
| Indirect Interest Through Control Of Middle Company | 35% |
| Deemed Interest Through Son - ITA 256(1.3) | 15% |
| Deemed Interest Through Options - ITA 256(1.4) | 10% |
| Controlling Interest | 75% |

**Middle And Bottom** Middle and Bottom are associated under ITA 256(1)(b) as they are both controlled by the same person, Mr. Top. Mr. Top controls Middle indirectly through Top. He controls Bottom through a combination of direct and indirect control, as described in the discussion of Top and Bottom.

### Exercise Fourteen - 5 Solution

With respect to the $125,000 in apprentice salaries, the investment tax credit is available on an annual salary maximum of $20,000 per apprentice. As a result, there will be a $10,000 [(5)(10%)($20,000)] credit against 2019 federal Tax Payable. This $10,000 credit will be added to income in 2020.

With respect to the $3,000,000 in capital expenditures, there will be a 2019 credit against federal Tax Payable of $300,000 [(10%)($3,000,000)]. The $300,000 credit will not influence the calculation of 2019 CCA. This amount will be $750,000 [(50%)(1/2)($3,000,000)].

In 2020, the $300,000 credit will be deducted from the January 1, 2020 UCC, leaving a balance of $1,950,000 ($3,000,000 - $750,000 - $300,000). Given this, 2020 CCA will be $975,000 [(50%)($1,950,000)].

### Exercise Fourteen - 6 Solution

For 2019, the A value in the reduction formula would be $2,500,000 ($12,500,000 - $10,000,000). Based on this, the amount that would be available for the enhanced 35 percent credit would be calculated as follows:

[$3,000,000][($40,000,000 – $2,500,000) ÷ $40,000,000] = $2,812,500

### Exercise Fourteen - 7 Solution

As Sci-Tech has Taxable Income of less than $500,000 in the previous year, and its Taxable Capital Employed in Canada is less than $10 million, it is a qualifying company and its annual expenditure limit is not reduced from the maximum value of $3,000,000.

Given the $3,000,000 annual expenditure limit for the 35 percent rate, the total amount of investment tax credits available can be calculated as follows:

| | |
|---|---:|
| Qualified Property [(10%)($123,000)] | $ 12,300 |
| SR&ED Current Expenditures [(35%)($1,200,000)] | 420,000 |
| Total Available Amount | $432,300 |

The refund available would be as follows:

| | |
|---|---:|
| Qualified Property [(40%)($12,300)] | $ 4,920 |
| SR&ED Current Expenditures [(100%)($420,000)] | 420,000 |
| Total Refund Available | $424,920 |

The non-refunded investment tax credit of $7,380 ($432,300 - $424,920) can be carried forward 20 years to be applied against Tax Payable. There was no Tax Payable in the last three years so it cannot be carried back.

The cost of the qualified property will be reduced in the following year by the refundable investment tax credit of $4,920. The $420,000 tax credit on current SR&ED expenditures will be added to income in the following taxation year.

### Exercise Fourteen - 8 Solution

The adjusted cost base of the shares would be determined as follows:

| | Number of Shares | Cost/Share | Total Cost |
|---|---:|---:|---:|
| First Purchase | 2,400 | $1.10 | $2,640 |
| Second Purchase | 3,850 | $1.82 | 7,007 |
| Totals | 6,250 | | $9,647 |

The adjusted cost base for all of the investor's shares is $9,647. The adjusted cost base per share would be $1.54 ($9,647 ÷ 6,250).

The PUC for the investor's shares would be calculated as follows:

| | Number of Shares | PUC/Share | Total PUC |
|---|---|---|---|
| First Sale | 100,000 | $1.10 | $110,000 |
| Second Sale | 50,000 | $1.35 | 67,500 |
| Third Sale | 30,000 | $1.82 | 54,600 |
| Total PUC Of Outstanding Shares | 180,000 | | $232,100 |

| | |
|---|---|
| Number Of Shares (From First Table) | 6,250 |
| PUC Per Share [$232,100 ÷ 180,000 Shares] | $ 1.29 |
| PUC For Investor's Shares | $8,063 |

### *Exercise Fourteen - 9 Solution*

The balance in the capital dividend account as at December 31, 2019 would be as follows:

| | |
|---|---|
| 2017 Capital Gain On Land [(1/2)($22,000)] | $11,000 |
| 2018 Capital Dividend Received | 8,200 |
| 2019 Sale Of Goodwill [(1/2)($43,000 - Nil)] | 21,500 |
| 2019 Capital Dividend Paid | ( 16,000) |
| Balance - End Of 2019 | $24,700 |

### *Exercise Fourteen - 10 Solution*

The required calculations are as follows:

| | |
|---|---|
| Fair Market Value Per Share | $25.00 |
| New Shares Received [(5%)(1,000)] | 50 |
| Non-Eligible Dividend Received | $1,250.00 |
| Gross Up [(15%)($1,250.00)] | 187.50 |
| Taxable Dividend | $1,437.50 |
| Dividend Tax Credit [(9/13)(15%)($1,250)] | $129.81 |

Jean's Net Income For Tax Purposes would be increased by the taxable dividend of $1,437.50. His federal Tax Payable would be decreased by the dividend tax credit of $129.81.

| | Number of Shares | ACB/Share | Total ACB |
|---|---|---|---|
| Pre-Dividend Shares | 1,000 | $18 | $18,000 |
| Stock Dividend Addition | 50 | $25 | 1,250 |
| Totals | 1,050 | | $19,250 |

The per share adjusted cost base of Jean's shares would be $18.33 ($19,250 ÷ 1,050).

### *Exercise Fourteen - 11 Solution*

The required calculations for the corporation are as follows:

| | |
|---|---|
| Proceeds Of Disposition [($51)(150,000)] | $7,650,000 |
| Adjusted Cost Base [($42)(150,000)] | ( 6,300,000) |
| Capital Gain | $1,350,000 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain | $ 675,000 |

The calculations for Sandrine are as follows:

| | |
|---|---|
| Dividend Received [(15%)($51)(150,000)] | $1,147,500 |
| Gross Up [(15%)($1,147,500)] | 172,125 |
| Taxable Dividend | $1,319,625 |
| Dividend Tax Credit [(9/13)(15%)($1,147,500)] | $ 119,163 |

Cloutier Ltd.'s Net Income For Tax Purposes would be increased by the $675,000 taxable capital gain. Sandrine's Net Income For Tax Purposes would be increased by the taxable dividend of $1,319,625. Her federal Tax Payable would be decreased by the dividend tax credit of $119,163.

### *Exercise Fourteen - 12 Solution*

This transaction will result in an ITA 84(1) deemed dividend for all shareholders, calculated as follows:

| | |
|---|---|
| PUC Of New Shares [(40,000)($12.70)] | $508,000 |
| Increase In Net Assets | ( 450,000) |
| ITA 84(1) Deemed Dividend | $ 58,000 |

This would be allocated to all 166,000 (126,000 + 40,000) shares outstanding, on the basis of $0.35 per share. This would be a taxable dividend, subject to either the eligible or non-eligible dividend gross up and tax credit procedures. The $0.35 per share dividend would also be added to the adjusted cost base of all 166,000 shares.

With the addition of $0.35 resulting from the ITA 84(1) deemed dividend to the original issue price of $10.50, the adjusted cost base of these shares is now $10.85 per share. Mr. Uni's sale of 5,000 shares at $13.42 per share would result in a taxable capital gain calculated as follows:

| | |
|---|---|
| Proceeds Of Disposition [($13.42)(5,000)] | $67,100 |
| Adjusted Cost Base [($10.85)(5,000)] | ( 54,250) |
| Capital Gain | $12,850 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain | $ 6,425 |

### *Exercise Fourteen - 13 Solution*

The analysis of the $2,350,000 distribution would be as follows:

| | |
|---|---|
| Cash Distributed | $2,350,000 |
| PUC Of Shares | ( 250,000) |
| ITA 84(2) Deemed Dividend | $2,100,000 |
| ITA 83(2) Capital Dividend | ( 340,000) |
| ITA 88(2)(b) Taxable Dividend | $1,760,000 |

To the extent the Company has a balance in its GRIP account, some amount of the $1,760,000 dividend could be designated as eligible. Any remainder will be taxed as a non-eligible dividend.

The wind-up results in a disposition of the shares. The tax consequences of this disposition are as follows:

| | |
|---|---|
| Cash Distributed | $2,350,000 |
| ITA 84(2) Deemed Dividend | ( 2,100,000) |
| ITA 54 Proceeds Of Disposition | $ 250,000 |
| Adjusted Cost Base | ( 250,000) |
| Capital Gain | Nil |

As shown by the preceding calculation, there would be no capital gain on the disposition.

### *Exercise Fourteen - 14 Solution*

The redemption transaction would have no tax consequences for Ms. Tandy. The tax consequences to Jesuiah Tandy resulting from the redemption of his shares would be as follows:

| | |
|---|---|
| Proceeds Of Redemption [(15,000)($11.75)] | $176,250 |
| PUC [(15,000)($8.25)] | ( 123,750) |
| ITA 84(3) Deemed Dividend | $ 52,500 |
| Gross Up Of 15 Percent | 7,875 |
| Taxable Dividend | $ 60,375 |

| | |
|---|---|
| Dividend Tax Credit [(9/13)(15%)($52,500)] | $ 5,452 |

| | |
|---|---|
| Proceeds Of Redemption [(15,000)($11.75)] | $176,250 |
| ITA 84(3) Deemed Dividend | ( 52,500) |
| ITA 54 Proceeds Of Disposition | $123,750 |
| Adjusted Cost Base [(15,000)($7.90)] | ( 118,500) |
| Capital Gain (PUC - ACB) | $ 5,250 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain | $ 2,625 |

Both the taxable dividend and the taxable capital gain would increase Jesuiah's Net Income For Tax Purposes by a total of $63,000 ($60,375 + $2,625). The federal dividend tax credit would decrease federal Tax Payable by $5,452.

### *Exercise Fourteen - 15 Solution*

To the extent of the $225,000 PUC reduction, the dividend will be treated as a tax free distribution. The tax consequences will be a reduction in the PUC of these shares to $225,000 ($450,000 - $225,000), as well as an adjusted cost base reduction to $400,000 ($625,000 - $225,000). The $105,000 ($330,000 - $225,000) excess of the distribution over the PUC reduction will be an ITA 84(4) deemed dividend, subject to either the eligible or non-eligible dividend gross up and tax credit procedures. As it will be taxed as a dividend, this part of the distribution will not be subtracted from the adjusted cost base of the shares.

## Self Study Solution Fourteen - 1

### *Part A - Non-Capital And Net Capital Losses*

**Net Business Loss** The net business loss for the period to March 31, 2019 would be as follows:

| | |
|---|---|
| Loss As Per March 31, 2019 Income Statement | ($23,000) |
| Required Accounts Receivable Adjustment ($45,000 - $33,000) | ( 12,000) |
| Building Election - Recaptured CCA ($285,000 - $270,000) | 15,000 |
| Fixtures And Equipment - Deemed CCA ($95,000 - $90,000) | ( 5,000) |
| Vehicles Election - Recaptured CCA ($87,000 - $80,000) | 7,000 |
| Net Business Loss For Period Ending March 31, 2019 | ($18,000) |

**Net And Taxable Income** Net Income For Tax Purposes and Taxable Income for the period ending March 31, 2019, calculated as per the ITA 3 rules, would be as follows:

| | | |
|---|---|---|
| ITA 3(a) - Non-Capital Income (Positive Amounts Only) | | Nil |
| ITA 3(b) - Net Taxable Capital Gains (Losses): | | |
| Elections Under ITA 111(4)(e): | | |
| Gain On Land [(1/2)($420,000 - $275,000)] | $ 72,500 | |
| Gain On Building [(1/2)($320,000 - $285,000)] | 17,500 | |
| Required Write-Down - ITA 111(4)(c) And (d) | | |
| Loss On Temporary Investments | | |
| [(1/2)($53,000 - $23,000)] | ( 15,000) | 75,000 |
| ITA 3(c) - Total | | $ 75,000 |
| ITA 3(d) - Business Loss For The Period | | ( 18,000) |
| Net Income For Tax Purposes | | $ 57,000 |
| Net Capital Loss Carry Forward | | |
| (Limited To Amount Included Under ITA 3(b) | | ( 75,000) |
| Taxable Income | | Nil |

**Lost Net Capital Loss** The net capital loss that would be lost would be calculated as follows:

| | |
|---|---|
| From 2017 [(1/2)($68,000)] | $34,000 |
| From 2018 [(1/2)($85,000)] | 42,500 |
| Net Capital Loss Balance At March 31, 2019 | $76,500 |
| Amount Deducted In 2019 | ( 75,000) |
| Net Capital Loss Lost On Acquisition of Control | $ 1,500 |

**Non-Capital Loss Carry Forward** The non-capital loss carry forward would be calculated as follows:

| | |
|---|---|
| Net Business Loss For Period | $ 18,000 |
| Net Capital Loss Deducted | 75,000 |
| Subtotal | $ 93,000 |
| Income Under ITA 3(c) | ( 75,000) |
| Non-Capital Loss For The Period Ending March 31, 2019 | $ 18,000 |
| Non-Capital Loss Carry Forward From 2017 | 63,500 |
| Non-Capital Loss Carry Forward From 2018 | 78,500 |
| Non-Capital Loss Carry Forward At March 31, 2019 | $160,000 |

### *Part B - Loss Carry Forward In 2019*

The April 1 to December 31, 2019 Net Income For Tax Purposes would be $78,000 ($123,000 - $45,000). Note that there is no restriction against deducting the current year loss on bread operations against other sources of income. However, none of the non-capital loss carry forward of $160,000 can be used as these losses can only be applied against income in the bread operations. This leaves the 2019 Taxable Income equal to the Net Income For Tax Purposes of $78,000. The non-capital loss carry forward at December 31, 2019 is unchanged at $160,000.

### *Part C - Loss Carry Forward In 2020*

The $40,000 loss on the figurines must be deducted from the profits of the bread operations to produce a Net Income For Tax Purposes of $171,000 ($211,000 - $40,000). As this income is entirely from bread operations, all of the $160,000 non-capital loss carry forward can be deducted, leaving a Taxable Income of $11,000. There is no remaining non-capital loss carry forward at December 31, 2020.

## Self Study Solution Fourteen - 2

### *Part A*

As a result of the acquisition of control, LF will have a deemed taxation year end on April 30, 2019. This results in a short January 1, 2019 through April 30, 2019 taxation year for LF. The effects of this include:

- An additional year will be counted towards the expiry of the non-capital losses.
- If CCA is to be taken, it will have to be calculated for a short fiscal period.
- All of the usual year end procedures (timing of bonuses, inclusion of reserves, etc.) will have to be carried out.
- For the first year after the acquisition of control, LF can choose a new fiscal year end, on any date up to 53 weeks after the deemed year end.

Other implications are as follows:

- Any net capital loss balance that that remains cannot be used after the deemed year end.
- Any non-capital loss balance that is carried forward can only be used against profits earned in the same or a similar line of business.
- The manufacturing equipment, because its fair market value is less than its UCC, will have to be written down to the $285,000 UCC value. The $90,000 ($375,000 - $285,000) amount of the write down will be treated as deemed CCA.

### *Part B*

The land, Class 1 assets, and Class 8 assets all have fair market values in excess of their tax values. If the deemed disposition election is made and the fair market value of these assets is used as the elected value, the results would be as follows:

| Asset | Recapture | Capital Gain |
|---|---:|---:|
| Land ($925,000 - $450,000) | N/A | $475,000 |
| Class 1 ($650,000 - $515,000) | $135,000 | Nil |
| Class 8 ($15,000 - $10,000) | 5,000 | Nil |
| Total Income | $140,000 | $475,000 |

### Part C

If the Companies believe that they will be able to generate sufficient income to use the non-capital loss carry forward in future periods, they will not want to make elections that will result in any unneeded pre-acquisition income. If the elections are made, the losses will increase the adjusted cost base or UCC balance of the assets the elections are made on. In the case of the land, the increased cost will not be of benefit until the land is sold. In the case of the depreciable assets, the increased UCC will only be deductible at the applicable rates of 4 or 20 percent. Alternatively, a non-capital loss carry forward can be deducted in full, as soon as the Companies have sufficient appropriate income to absorb it.

The situation with net capital losses is different. If such losses are not used during the short fiscal period prior to the acquisition of control, they will be lost forever. Given this, it would be appropriate to make an election that would absorb the $65,000 net capital loss from 2017. This will require a capital gain of $130,000 [(2)($65,000)] which can be created by electing a deemed disposition on the land at a value of $580,000. This election will create a taxable capital gain of $65,000 [(1/2)($580,000 - $450,000)].

Given the required write-down of the manufacturing equipment, the Net Business Loss would be calculated as follows:

| | |
|---|---|
| Operating Loss To April 30, 2019 (Given) | ($ 55,000) |
| Deemed CCA On Class 53 ($375,000 - $285,000) | ( 90,000) |
| Net Business Loss For The Period Ending April 30, 2019 | ($145,000) |

Using this figure, along with the results of the election on the land, Net and Taxable Income would be calculated as follows:

| | |
|---|---|
| ITA 3(a) Non-Capital Income (Positive Amounts Only) | Nil |
| ITA 3(b) Net Taxable Capital Gains | |
| Election Under ITA 111(4)(e) On Land | $ 65,000 |
| ITA 3(c) Total | $ 65,000 |
| ITA 3(d) Net Business Loss For The Period | ( 145,000) |
| Net Income For Tax Purposes | Nil |
| Net Capital Loss Carry Forward (See Following) | ($ 65,000) |
| Taxable Income | Nil |

The non-capital loss carry forward at April 30, 2019 would be calculated as follows:

| | |
|---|---|
| Net Business Loss For The Period | $145,000 |
| Net Capital Loss Deducted | 65,000 |
| Subtotal | $210,000 |
| Income Under ITA 3(c) | ( 65,000) |
| Non-Capital Loss For The Period Ending April 30, 2019 | $145,000 |
| Carry Forward From 2017 | 180,000 |
| Carry Forward From 2018 | 140,000 |
| Non-Capital Loss Carry Forward | $465,000 |

The net capital loss balance from 2017 would be eliminated by the $65,000 carry forward deduction, leaving a balance of nil to be carried forward.

***Part D***

If there is uncertainty with respect to the ability of OLC and LF to generate income in the same or similar line of business in amounts sufficient to absorb the non-capital loss carry forward, additional elections should be made to absorb as much of this balance as possible. This would require elections on all of the assets with capital gains or recapture. Under this approach Net Business Income would be calculated as follows:

| | |
|---|---|
| Operating Loss To April 30, 2019 (Given) | ($ 55,000) |
| Deemed CCA On Class 53 ($375,000 - $285,000) | ( 90,000) |
| Class 1 - Recaptured CCA | 135,000 |
| Class 8 - Recaptured CCA | 5,000 |
| Net Business Loss For The Period Ending April 30, 2019 | ($ 5,000) |

The resulting Net and Taxable Income amounts would be calculated as follows:

| | |
|---|---|
| ITA 3(a) - Non-Capital Income (Positive Amounts Only) | Nil |
| ITA 3(b) - Net Taxable Capital Gains (Losses): | |
| Capital Gain On Land [(1/2)($925,000 - $450,000)] | $237,500 |
| ITA 3(c) - Total | $237,500 |
| ITA 3(d) - Business Loss For The Period | ( 5,000) |
| Net Income For Tax Purposes | $232,500 |
| Net Capital Loss Carry Forward (All) | ( 65,000) |
| Subtotal | $167,500 |
| Non-Capital Loss Carry Forward | |
| (Maximum Needed To Reduce Income To Nil) | ( 167,500) |
| Taxable Income | Nil |

Under this Part D approach, the non-capital loss carry forward at April 30, 2019 would be calculated as follows:

| | |
|---|---|
| Net Business Loss For The Period | $ 5,000 |
| Net Capital Loss Deducted | 65,000 |
| Subtotal | $ 70,000 |
| Income Under ITA 3(c) | ( 237,500) |
| Non-Capital Loss For The Period Ending April 30, 2019 | Nil |

| | |
|---|---|
| Carry Forward From 2017 | $180,000 |
| Carry Forward From 2018 | 140,000 |
| Non-Capital Loss Carry Forward Deducted | |
| For The Period Ending April 30, 2019 | ( 167,500) |
| Non-Capital Loss Carry Forward | $152,500 |

As in Part C, the net capital loss from 2017 is eliminated by the $65,000 loss carry forward deduction.

## Self Study Solution Fourteen - 3

***Part A***

By virtue of ITA 251(2)(a), John Fleming and Eric Flame are related by the fact that they are married to persons who are connected by a blood relationship (their wives). In addition, under ITA 256(1.5) a person who owns shares in two or more corporations shall be, as a shareholder of one of the corporations, deemed to be related to himself as a shareholder of the other corporation(s).

Given this, Fleming Ltd. and Lartch Inc. are associated under ITA 256(1)(d). John Fleming controls Fleming Ltd., is a member of a related group (John Fleming and Eric Flame) that controls Lartch Inc., and owns more than 25 percent of the voting shares of Lartch Inc.

In a similar fashion, Flame Ltd. is associated with Lartch Inc. under ITA 256(1)(d), as Eric Flame controls Flame Ltd., is a member of a related group (John Fleming and Eric Flame) that controls Lartch Inc., and owns more than 25 percent of Lartch Inc.

Based on these associations, Fleming Ltd. and Flame Ltd. are associated under ITA 256(2), as they are both associated with a third corporation, Lartch Inc. If it was desirable, Lartch Inc. could make the appropriate election under ITA 256(2) to be deemed not to be associated with Fleming Ltd. and Flame Ltd. which would allow Fleming Ltd. and Flame Ltd. to avoid association. However, the annual business limit for Lartch Inc. would be reduced to nil.

### Part B

Mr. and Mrs. Cuso are a group with respect to both Male Ltd. and Female Inc. [ITA 256(1.2)(a) - two or more persons holding shares in the same corporation]. As a group, they control both Male Ltd. and Female Inc. Therefore, the two Companies are associated under ITA 256 (1)(b). The fact that Mr. and Mrs. Cuso are related is not relevant.

### Part C

Ms. Jones and Miss Lange are a group that controls Alliance Ltd. However, they do not control Breaker Inc., as Mrs. Kelly (not a member of the group that controls Alliance Ltd.) owns 50 percent of the shares. Therefore, Alliance Ltd. and Breaker Inc. are not associated.

### Part D

While they are not related, Mr. Martin and Mr. Oakley constitute a group [ITA 256(1.2)(a)] with respect to both Martin Inc. and Oakley Ltd. As both Martin Inc. and Oakley Ltd. are controlled by the same group, the two Companies are associated under ITA 256(1)(b).

### Part E

The two Companies are related, but not associated. While Lily and James are related, they are not a group with respect to the two Companies and there is no cross-ownership of shares.

## Self Study Solution Fourteen - 4

### Case 1

As a group, Mr. Jones and Mr. Twitty control both Jones Ltd. and Twitty Inc. As a consequence, these two Companies would be associated under ITA 256(1)(b).

### Case 2

Ms. Wynette controls Wynette Enterprises Ltd., and is related to each member of the group that controls Lynn Inc. In addition, Ms. Wynette has the necessary 25 percent plus cross-ownership in Lynn Inc. As a consequence, Wynette Enterprises Ltd. and Lynn Inc. are associated under ITA 256(1)(d).

### Case 3

A group, consisting of Mr. Travis and Mr. Cash, has control of both Cowboys Ltd. and Horses Inc. Therefore, Cowboys Ltd. and Horses Inc. are associated under ITA 256(1)(b).

### Case 4

As Randy's Boots Inc. controls Hill Inc., those two companies are associated under ITA 256(1)(a).

As Mr. Nelson owns 80 percent of the shares of Willie's Hits Ltd., he controls that company. This gives him control over the 20 percent of Hill Inc. shares that are owned by Willie's Hits.

However, Mr. Nelson does not control Randy's Boots, and this means that his indirect interest in Hill Inc. through Randy's Boots of 24 percent [(30%)(80%)] is the product of the two ownership percentages.

As a result, his overall interest in Hill Inc. is only 44 percent (20% + 24%), which is not sufficient to give him control over Hill. Therefore, Willie's Hits Ltd. and Hill Inc. are not associated and Willie's Hits Ltd. and Randy's Boots Inc. are not associated.

### *Case 5*

Ms. Parton controls Alpha Company, is related to each member of the group (Ms. Parton and her spouse) that control Beta Company, and has cross-ownership of Beta Company in excess of 25 percent. This means that these two Companies are associated under ITA 256(1)(d).

Her spouse controls Centra Company, is related to each member of the group (the spouse and Ms. Parton) that controls Beta Company, and has the necessary cross-ownership of at least 25 percent of Beta Company shares. This means that these two Companies are also associated under ITA 256(1)(d).

As they are not controlled by the same individual or group, Alpha Company and Centra Company are not associated under ITA 256(1). However, as they are both associated with the same third corporation (Beta Company), Alpha and Centra would be associated under ITA 256(2). Note that ITA 256(2) allows Alpha and Centra to avoid association, provided Beta elects not to be associated with either Company. This will mean, however, that Beta will have a business limit for the period of nil.

### *Case 6*

For the purposes of determining associated companies, Ms. Gale is deemed to own the 30 percent interest in Norton Music Inc. that is held by her minor child [ITA 256(1.3)] and the 20 percent interest in Norton Music Inc. for which she holds an option [ITA 256(1.4)]. When this is combined with her own interest of 10 percent, she would be considered to control Norton Music Inc. As she controls both Kristal Enterprises Ltd. and Norton Music Inc., these Companies are associated under ITA 256(1)(b).

## Self Study Solution Fourteen - 5

### *Case A*

Luxor's annual expenditure limit would be $2,887,500. This amount is calculated as follows:

[$3,000,000][($40,000,000 – $1,500,000) ÷ $40,000,000]

### *Case B*

Gargle's annual expenditure limit would be $2,827,500, calculated as follows:

[$3,000,000][($40,000,000 – $2,300,000) ÷ $40,000,000]

As the eligible SR&ED current expenditures exceed this limit, some of the expenditures will only be eligible for the 15 percent rate:

| | |
|---|---|
| Total Current SR&ED Expenditures | $3,200,000 |
| Annual Expenditure Limit (Eligible For 35 Percent Rate) | ( 2,827,500) |
| Limited To 15 Percent Rate | $ 372,500 |

The total amount of investment tax credits available can be calculated as follows:

| | |
|---|---|
| Qualified Property [(10%)($86,000)] | $ 8,600 |
| SR&ED Current Expenditures: | |
| At 35 Percent Rate [(35%)($2,827,500)] | 989,625 |
| At 15 Percent Rate [(15%)($372,500)] | 55,875 |
| Total Available Amount | $1,054,100 |

Gargle is a qualifying corporation. The refund available would be as follows:

| | Rate | ITC | Refund |
|---|---|---|---|
| Qualified Property | 40% | $ 8,600 | $ 3,440 |
| SR&ED Current Expenditures | 100% | 989,625 | 989,625 |
| SR&ED Current Expenditures | 40% | 55,875 | 22,350 |
| Total Available | | $1,054,100 | $1,015,415 |

The non-refunded investment tax credit of $38,685 ($1,054,100 - $1,015,415) can be carried forward 20 years to be applied against Tax Payable. There was no Tax Payable in the last three years so it cannot be carried back.

The cost of the qualified property will be reduced in 2020 by the refundable investment tax credit of $3,440. The $1,011,975 ($989,625 + $22,350) refundable tax credit on current SR&ED expenditures will be added to income in 2020.

### *Case C*

With respect to the $250,000 in apprentice salaries, the investment tax credit is available on an annual salary maximum of $20,000 per apprentice. As a result, there will be a $17,500 [(5)(10%)($15,000) + (5)(10%)($20,000 maximum)] credit against 2018 federal Tax Payable. This $17,500 credit will be added to income in 2019.

With respect to the $800,000 in capital expenditures, there will be a 2019 credit against federal Tax Payable of $80,000 [(10%)($800,000)].

The $80,000 credit will not influence the calculation of 2018 CCA. This amount will be $360,000 [(30%)(150%)($800,000)].

In 2019, the $80,000 credit will be deducted from the January 1, 2019 UCC, leaving a balance of $360,000 ($800,000 - $360,000 - $80,000). Given this, 2019 CCA will be $108,000 [(30%)($360,000)].

## Self Study Solution Fourteen - 6

The December 31, 2019 balance in the capital dividend account is calculated as follows:

| | |
|---|---|
| 2008 Capital Gain [(1/2)($343,500 - $225,000)] | $ 59,250 |
| 2009 Life Insurance Proceeds | 162,000 |
| 2011 Capital Loss [(1/2)($150,000 - $220,000)] | ( 35,000) |
| 2013 Capital Dividend Received | 26,000 |
| 2017 Net Capital Loss | |
| {[1/2][($80,000 - $50,000) - ($100,000 - $45,000)]} | ( 12,500) |
| Capital Dividends Paid [(3)($45,000)] | ( 135,000) |
| Balance December 31, 2019 | $ 64,750 |

## Self Study Solution Fourteen - 7

The December 31, 2019 balance in the capital dividend account is calculated as follows:

| | |
|---|---|
| 2008 Life Insurance Proceeds | $186,000 |
| 2010 Capital Dividend Received | 26,300 |
| 2015 Capital Dividend Paid | ( 45,200) |
| 2016 Capital Gain [(1/2)($226,100 - $184,300)] | 20,900 |
| 2018 Capital Gain [(1/2)($93,400 - $48,600)] | 22,400 |
| 2018 Capital Loss [(1/2)($108,300 - $112,600)] | ( 2,150) |
| 2019 Capital Dividend Paid | ( 16,400) |
| Balance December 31, 2019 | $191,850 |

## Self Study Solution Fourteen - 8

***Case 1***

To the extent of the $163,000 PUC reduction, the liquidating dividend will be treated as a tax free distribution to Mr. Farnsworth. However, there will be tax consequences related to this distribution:

- The PUC of Mr. Farnsworth's shares will be reduced to $160,000 ($323,000 - $163,000).
- The ACB of Mr. Farnsworth's shares will be reduced to $299,000 ($462,000 - $163,000).

The $97,000 ($260,000 - $163,000) excess of the distribution over the PUC reduction will be an ITA 84(4) deemed dividend. For inclusion in Taxable Income, it will be grossed up to $111,550 [(115%)($97,000)]. It will generate a federal dividend tax credit of $10,073 [(9/13)(15%)($97,000)]. This deemed dividend part of the distribution will not be subtracted from the adjusted cost base of the shares.

***Case 2***

The tax consequences to Michelle Chawla resulting from the redemption of her shares would be as follows:

| | |
|---|---|
| Proceeds Of Redemption [($20.80)(125,000)] | $2,600,000 |
| PUC [($20)(125,000)] | ( 2,500,000) |
| ITA 84(3) Deemed Dividend | $ 100,000 |

| | |
|---|---|
| Proceeds Of Redemption [($20.80)(125,000)] | $2,600,000 |
| ITA 84(3) Deemed Dividend | ( 100,000) |
| ITA 54 Proceeds Of Disposition | $2,500,000 |
| Adjusted Cost Base [($16.80)($125,000)] | ( 2,100,000) |
| Capital Gain | $ 400,000 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain | $ 200,000 |

For purposes of determining Taxable Income, the ITA 84(3) dividend will be grossed up to $115,000 [(115%)($100,000)], resulting in a total increase in Taxable Income of $315,000 ($115,000 + $200,000). A federal dividend tax credit of $10,385 [(9/13)(15%)($100,000)] will result from this transaction.

### *Case 3*

This transaction will result in an ITA 84(1) deemed dividend for all shareholders, calculated as follows:

| | |
|---|---|
| PUC Of New Shares [(42,000)($24.10)] | $1,012,200 |
| Increase In Net Assets (Liability Eliminated) | ( 900,000) |
| ITA 84(1) Deemed Dividend | $ 112,200 |

This would be allocated to all 275,000 (233,000 + 42,000) shares outstanding, on the basis of $0.408 per share ($112,200 ÷ 275,000).

Sue's share of the dividend would be $9,506 [(23,300)($0.408)]. For inclusion in her Taxable Income, this amount will be grossed up to $10,932 [(115%)($9,506)].

The deemed dividend will be added to the adjusted cost base of Sue's shares, resulting in a value of $22.908 ($22.50 + $0.408)] per share. A federal dividend tax credit of $987 [(9/13)(15%)($9,506)] will result from this transaction.

The tax consequences of Sue selling her shares would be as follows:

| | |
|---|---|
| Proceeds Of Disposition [(23,300)($24.85)] | $579,005 |
| Adjusted Cost Base [(23,300)($22.908)] | ( 533,756) |
| Capital Gain | $ 45,249 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain | $ 22,625 |

This will result in a total increase in Taxable Income of $33,557 ($22,625 + $10,932).

### *Case 4*

The analysis of the $3,175,000 distribution would be as follows:

| | |
|---|---|
| Cash Distributed | $3,175,000 |
| PUC Of Shares | ( 400,000) |
| ITA 84(2) Deemed Dividend | $2,775,000 |
| ITA 83(2) Capital Dividend | ( 427,000) |
| ITA 88(2)(b) Wind-Up Dividend | $2,348,000 |

The capital dividend would be distributed tax free. For inclusion in Taxable Income, the $2,348,000 dividend would be grossed up to $2,700,200 [(115%)($2,348,000)]. It would generate a federal dividend tax credit of $243,831 [(9/13)(15%)($2,348,000)].

The transaction would also result in an allowable capital loss calculated as follows:

| | |
|---|---|
| Cash Distributed | $3,175,000 |
| ITA 84(2) Deemed Dividend | ( 2,775,000) |
| ITA 54 Proceeds Of Disposition | $ 400,000 |
| Adjusted Cost Base | ( 1,450,000) |
| Capital Loss | ($1,050,000) |
| Inclusion Rate | 1/2 |
| Allowable Capital Loss | ($ 525,000) |

The allowable capital loss can be used in the current year, only to the extent of taxable capital gains realized in the current year.

## Chapter 14 Learning Objectives

After completing Chapter 14, you should be able to:

1. Explain the need for, and the tax implications of, a deemed year end when there has been an acquisition of control (paragraph [P hereafter] 14-1 to 14-13).
2. Apply the provisions related to charitable donations and loss carry forwards when there has been an acquisition of control (P 14-14 to 14-21).
3. Explain the treatment of unrecognized losses at a deemed year end resulting from an acquisition of control (P 14-22 to 14-34).
4. Apply the associated companies rules (P 14-35 to 14-52).
5. Apply the general rules applicable to investment tax credits and SR & ED expenditures by CCPCs (P 14-53 to 14-65).

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6. Apply the provisions related to refundable investment tax credits (P 14-66 to 14-70).
7. Apply the carry over rules for investment tax credits, as well as describe the influence of an acquisition of control on their availability (P 14-71 to 14-75).
8. Explain the relationship between tax basis Shareholders' Equity and Shareholders' Equity as presented under GAAP (P 14-76 to 14-78).
9. Explain the concept of, and calculate the amount of, Paid Up Capital (P 14-79 to 14-82).
10. Identify and explain the major components of Tax Basis Retained Earnings (P 14-83 to 14-91).

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11. Explain the objectives of, and list the major components of, the capital dividend account (P 14-92 to 14-95).
12. List the various types of dividends used to distribute corporate surplus (P 14-96 to 14-100).
13. Apply the procedures related to the declaration and payment of cash dividends (P 14-101 to 14-104).
14. Apply the procedures related to the declaration and payment of stock dividends (P 14-105 to 14-107).
15. Apply the procedures related to the declaration and payment of dividends in kind (P 14-108 to 14-110).

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16. Apply the procedures related to the declaration and payment of capital dividends (P 14-111 to 14-115).
17. Explain and apply the procedures related to ITA 84(1) deemed dividends when there has been an increase in PUC (P 14-116 to 14-121).
18. Explain and apply the procedures related to ITA 84(2) deemed dividends on winding up (P 14-122 to 14-126).
19. Explain and apply the procedures related to ITA 84(3) deemed dividends on redemption, acquisition or cancellation of shares (P 14-127 to 14-130).
20. Explain and apply the procedures related to ITA 84(4) and 84(4.1) deemed dividends (P 14-131 to 14-136).

# CHAPTER 15

## How To Work Through Chapter 15

We recommend the following approach in dealing with the material in this chapter:

**The Decision To Incorporate - Tax Considerations**

- Read paragraph 15-1 to 15-9 (in the textbook).

**Other Advantages And Disadvantages Of Incorporation**

- Read paragraph 15-10 to 15-11.
- Do Self Study Problems Fifteen-1 and Fifteen-2 which is available on MyLab and check the solutions in this Study Guide.

**Basic Example Data - Tax Reduction And Deferral**

- Read paragraph 15-12 to 15-24.

**Public Companies - Tax Reduction And Deferral**

- Read paragraph 15-25 to 15-34.
- Do Exercise Fifteen-1 (in the textbook) and check the solution in this Study Guide.

**CCPCs - Active Business Income - Tax Reduction And Deferral**

- Read paragraph 15-35 to 15-40.
- Do Exercise Fifteen-2 and check the solution in this Study Guide.
- Read paragraph 15-41 to 15-45.

**CCPCs - Non-Dividend Investment Income - Tax Reduction And Deferral**

- Read paragraph 15-46 to 15-49.
- Do Exercise Fifteen-3 and check the solution in this Study Guide.
- Do Self Study Problem Fifteen-3 and check the solution in this Study Guide.

**CCPCs - Dividend Income - Tax Reduction And Deferral**

- Read paragraph 15-50 to 15-54.

**Conclusions On Tax Reductions And Deferrals**

- Read paragraph 15-55 to 15-57.
- Do Exercises Fifteen-4 and Fifteen-5 and check the solutions in this Study Guide.
- Do Self Study Problem Fifteen-4 and check the solution in this Study Guide.

**Provincial Taxes And Integration**

- Read paragraph 15-58 to 15-76.
- Do Self Study Problem Fifteen-5 and check the solution in this Study Guide.

**Tax-Free Dividend Calculations**

- Read paragraph 15-77 to 15-88.

### Income Splitting

- Read paragraph 15-89 to 15-91.
- Do Self Study Problem Fifteen-6 and check the solution in this Study Guide.

### Shareholder Benefits Including Loans

- Read paragraph 15-92 to 15-113.
- Do Exercises Fifteen-6 to Fifteen-8 and check the solutions in this Study Guide.
- Do Self Study Problems Fifteen-7 and Fifteen-8 and check the solutions in this Study Guide.

### Management Compensation - General Principles

- Read paragraph 15-114 to 15-120.

### Salary Vs. Dividend Decisions For The Owner-Manager

- Read paragraph 15-121 to 15-151.
- Do Exercise Fifteen-9 and check the solution in this Study Guide.

### Salary Vs. Dividends - Use Of Tax Credits

- Read paragraph 15-152 to 15-168.
- Do Exercises Fifteen-10 and Fifteen-11 and check the solutions in this Study Guide.

### Salary Vs. Dividends - Conclusion

- Read paragraph 15-169 to 15-170.
- Do Self Study Problems Fifteen-9 to Fifteen-11 and check the solutions in this Study Guide.

### To Complete This Chapter

- If you would like more practice in problem solving, do the Supplementary Self Study Problems for the chapter. These problems and solutions are available on MyLab.
- Review the Key Terms Used In This Chapter in the textbook at the end of Chapter 15. Consult the Glossary for the meaning of any key terms you do not know.
- Test yourself with the Chapter 15 Glossary Flashcards available on MyLab.
- Ensure you have achieved the Chapter 15 Learning Objectives listed in this Study Guide.
- As a review, we recommend you view the PowerPoint presentation for Chapter 15 that is on MyLab.

### Practice Examination

- Write the Practice Examination for Chapter 15 that is on MyLab. Mark your examination using the Practice Examination Solution that is on MyLab.

# Solutions to Chapter Fifteen Exercises

### *Exercise Fifteen - 1 Solution*

As the new corporation would not be allocated any part of the annual business limit, all of the $100,000 would be taxed at full corporate rates:

| | |
|---|---|
| Corporate Income | $100,000 |
| Corporate Taxes [(26.5%)($100,000)] | ( 26,500) |
| Available For Eligible Dividends | $ 73,500 |

| | |
|---|---|
| Eligible Dividends Received By Ms. Ashley | $ 73,500 |
| Gross Up At 38 Percent | 27,930 |
| Taxable Dividends | $101,430 |
| Ms. Ashley's Tax Rate | 45% |
| Tax Payable Before Dividend Tax Credit | $ 45,644 |
| Dividend Tax Credit [(6/11 + 47.1%)($27,930)] | ( 28,390) |
| Personal Tax Payable | $ 17,254 |

| | |
|---|---|
| Eligible Dividends Received | $73,500 |
| Tax Payable | ( 17,254) |
| After Tax Retention | $56,246 |

This Exercise uses a below average corporate tax rate and an above average provincial dividend tax credit, both of which are favourable to the use of a corporation. Even with these favourable rates, use of a corporation only improves the after tax retention by $1,246 ($56,246 - $55,000).

### *Exercise Fifteen - 2 Solution*

Mr. Slater's combined tax rate on income earned by the unincorporated business is 49 percent (33% + 16%). If he incorporates, all of the $126,000 will be eligible for the small business deduction. This means it will be taxed at a corporate rate of 12 percent (38% - 10% - 19% + 3%). Mr. Slater's tax rate on non-eligible dividend income is 41.95 percent [(115%)(49%) - (9/13 + 27%)(15%)].

Using these tax rates, a comparison of the income retained with and without the use of a corporation is as follows:

| | With Corporation | Without Corporation |
|---|---|---|
| Business Income | $126,000 | $126,000 |
| Tax Rate | 12% | 49% |
| Tax Payable | $ 15,120 | $ 61,740 |
| Business Income | $126,000 | $126,000 |
| Tax Payable | ( 15,120) | ( 61,740) |
| Maximum Non-Eligible Dividend Payable | $110,880 | N/A |
| Personal Tax On Dividends [(41.95%)($110,880)] | ( 46,514) | N/A |
| After Tax Income Retained By Mr. Slater | $ 64,366 | $ 64,260 |

There is clearly a significant amount of tax deferral with respect to income left in the corporation. His Tax Payable on direct receipt of the $126,000 of business income would be $61,740, far higher than the $15,120 that would be paid by the corporation. There would also be a small tax savings as the $64,366 in income retained using the corporation is $106 greater than the $64,260 in income retained without the use of the corporation.

### *Exercise Fifteen - 3 Solution*

Mr. Slater's combined tax rate on interest income earned outside the corporation is 51 percent (33% + 18%). His tax on the direct receipt of $126,000 of interest income would be $64,260.

If he incorporates, the interest income will not be eligible for the small business deduction or the general rate reduction, and it will be subject to the ART. This means that, if the investments are transferred to a corporation, the interest will be taxed at a rate of 50-2/3 percent (38% - 10% + 10-2/3% + 12%). Mr. Slater's tax rate on non-eligible dividends received is 44.2 percent [(115%)(51%) - (9/13 + 27%)(15%)].

Using these tax rates, a comparison of the income retained with and without the use of a corporation is as follows:

| | With Corporation | Without Corporation |
|---|---|---|
| Interest Income | $126,000 | $126,000 |
| Tax Rate | 50-2/3% | 51% |
| Tax Payable | $ 63,840 | $ 64,260 |
| Interest Income | $126,000 | $126,000 |
| Tax Payable | ( 63,840) | ( 64,260) |
| Net Corporate Income Before Dividend Refund | $ 62,160 | N/A |
| Maximum Dividend Refund (See Note) | 38,640 | |
| Maximum Dividend Payable | $100,800 | |
| Personal Tax On Dividends [(44.2%)($100,800)] | ( 44,554) | |
| After Tax Income Retained By Mr. Slater | $ 56,246 | $ 61,740 |

As this would be a new corporation, it would have no transitional RDTOH balance from 2018. Given this, the balance in the Non-Eligible RDTOH would as follows:

| | |
|---|---|
| Non-Eligible RDTOH Balance [(30-2/3%)($126,000)] | $ 38,640 |

**Note** The refund is the lesser of 38-1/3 percent of dividends paid and the balance in the Non-Eligible RDTOH account. The available cash of $62,160 would support a dividend of $100,800 ($62,160 ÷ .61667), which includes a potential dividend refund of $38,640 [(38-1/3%)($100,800)]. In this case the two figures are both equal to $38,640.

With Mr. Slater's individual tax rate at 51 percent and the corporate tax rate at 50-2/3 percent, there is a very small amount of deferral. The amount would be $420 ($64,260 - $63,840), not enough to justify the tax cost associated with using a corporation.

The after tax retention results with a corporation are significantly worse than when the income is received directly. After tax retention is reduced from $61,740 to $56,246, a reduction of $5,494. There is clearly a tax cost as a result of transferring the investments to a corporation.

### *Exercise Fifteen - 4 Solution*

**Direct Receipt** If the income is received directly, the total Tax Payable will be as follows:

| | | |
|---|---|---|
| Eligible Dividends Received | $46,000 | |
| Gross Up At 38 Percent | 17,480 | $ 63,480 |
| Non-Eligible Dividends Received | $87,000 | |
| Gross Up At 15 Percent | 13,050 | 100,050 |
| Taxable Dividends | | $163,530 |
| Interest Income | | 32,000 |
| Taxable Income | | $195,530 |
| Personal Tax Rate (33% + 18%) | | 51% |
| Tax Payable Before Dividend Tax Credit | | $ 99,720 |
| Dividend Tax Credit | | |
| [(6/11 + 5/11)($17,480)] | ($17,480) | |
| [(9/13 + 4/13)($13,050)] | ( 13,050) | ( 30,530) |
| Personal Tax Payable | | $ 69,190 |

The after tax retention can be calculated as follows:

| | |
|---|---|
| Cash Received ($46,000 + $87,000 + $32,000) | $165,000 |
| Tax Payable | ( 69,190) |
| After Tax Retention - Direct Receipt | $ 95,810 |

**Transfer To Corporation** If the investments are transferred to a corporation, the tax rate on the interest income is 50-2/3 percent (38% - 10% + 10-2/3% + 12%). Given this, the corporate taxes will be as follows:

| | |
|---|---|
| Part IV Tax On Eligible Dividends Received [(38-1/3%)($46,000)] | $17,633 |
| Part IV Tax On Non-Eligible Dividends Received (100% Of The Dividend Refund Received The Subsidiary) | 29,000 |
| Tax On Interest Income [(50-2/3%)($32,000)] | 16,213 |
| Corporate Tax Payable Before Refund | $62,846 |

As this Tax Payable is smaller than the Tax Payable that would be paid on the direct receipt of income, the use of a corporation provides significant tax deferral. However, as the client needs all of the income produced by these investments, this advantage will not be used by him.

As this would be a new corporation, it would have no transitional RDTOH balance from 2018. Given this, the balance in the Eligible RDTOH would equal the Part IV tax on the eligible dividends received and would as follows:

| | |
|---|---|
| Eligible RDTOH Balance [(38-1/3%)($46,000)] | $17,633 |

The balance in the Non-Eligible RDTOH would be as follows:

| | |
|---|---|
| Part IV Tax On Non-Eligible Dividends Received | $29,000 |
| Part I Addition [(30-2/3%)($32,000)] | 9,813 |
| Non-Eligible RDTOH Balance | $38,813 |

The cash available for paying dividends would be $102,154 ($165,000 - $62,846). This represents 61.667 percent of $165,654. Paying a dividend in this amount would result in a refund of $63,500 [(38-1/3%)($165,654). However, this exceeds the sum of the RDTOH balances. This means that the total refund would be limited to $56,446 ($17,633 + $38,813), with a total dividend of $158,600 ($102,154 + $56,446).

The eligible dividends received by the corporation will be added to the GRIP balance, leaving $46,000 in this account. This means that $46,000 in dividends could be designated as eligible for the enhanced dividend gross up and tax credit procedures. The remainder of the dividends paid of $112,600 ($158,600 - $46,000) would be non-eligible.

This would result in personal taxes as follows:

| | | |
|---|---|---|
| Eligible Dividends Received | $46,000 | |
| Gross Up At 38 Percent | 17,480 | $ 63,480 |
| Non-Eligible Dividends Received | $112,600 | |
| Gross Up At 15 Percent | 16,890 | 129,490 |
| Taxable Dividends | | $192,970 |
| Personal Tax Rate | | 51% |
| Tax Payable Before Dividend Tax Credit | | $ 98,415 |
| Dividend Tax Credit | | |
| [(6/11 + 5/11)($17,480)] | ($17,480) | |
| [(9/13 + 4/13)($16,890)] | ( 16,890) | ( 34,370) |
| Personal Tax Payable | | $ 64,045 |

| | |
|---|---|
| Dividends Received ($46,000 + $112,600) | $158,600 |
| Personal Tax Payable | ( 64,045) |
| After Tax Retention - With Corporation | $ 94,555 |

As this is less than the $95,810 that would be retained on direct receipt of income, there is no tax advantage in going to the trouble and expense of forming a corporation to hold the client's investments.

### *Exercise Fifteen - 5 Solution*

The client's combined tax rate on direct receipt of income is 49 percent (33% + 16%). Based on this, the after tax amount retained on direct receipt of income can be calculated as follows:

| | |
|---|---|
| Capital Gain | $92,000 |
| Personal Taxes On Taxable Capital Gain [(49%)(1/2)($46,000)] | ( 22,540) |
| After Tax Retention - Direct Receipt | $69,460 |

If the investments are transferred to a CCPC, the aggregate investment income will be $46,000 [(1/2)($92,000)]. The applicable tax rate will be 50-2/3% (38% - 10% + 10-2/3% + 12%). As this rate is higher than the client's personal rate on income received directly, there would be no possible deferral of tax through the use of a corporation. However, even if the rate was more favourable, deferral is not an issue here as the client needs all of the income produced by these investments for her forthcoming bicycle trip.

Based on this corporate tax rate, the maximum distribution that can be made would be calculated as follows:

| | |
|---|---|
| Available Cash | $92,000 |
| Corporate Tax Payable [(50-2/3%)($46,000)] | ( 23,307) |
| Tax Free Capital Dividend [(1/2)($92,000)] | ( 46,000) |
| Available For Non-Eligible Dividend | $22,693 |
| Dividend Refund (See Note) | 14,107 |
| Non-Eligible Dividend Received | $36,800 |

As this would be a new corporation, it would have no transitional RDTOH balance from 2018. Given this, the balance in the Non-Eligible RDTOH would as follows:

| | |
|---|---|
| Non-Eligible RDTOH Balance [(30-2/3%)($46,000)] | $14,107 |

**Note** The refund is the lesser of 38-1/3 percent of dividends paid and the balance in the Non-Eligible RDTOH account. The available cash of $22,693 would support a dividend of $36,800 ($22,693 ÷ .61667 with a $1 rounding error), which includes a potential dividend refund of $14,107 [(38-1/3%)($36,800)]. In this case, the two figures are both equal to $14,107.

The client's tax rate on non-eligible dividend income is 41.35 percent [(115%)(49%) - (9/13 + 4/13)(15%)]. Based on this, the net after tax retention when a corporation is used would be as follows:

| | |
|---|---|
| Tax Free Capital Dividend Received | $46,000 |
| Non-Eligible Dividend Received | 36,800 |
| Tax Payable On Non-Eligible Dividend Received [(41.35%)($36,800)] | ( 15,217) |
| After Tax Retention - With Corporation | $67,583 |

As this is less than the $69,460 that would be retained on direct receipt of the income, there is no tax advantage in going to the trouble and expense of forming a corporation to hold the client's investments.

### *Exercise Fifteen - 6 Solution*

It is likely that Ms. Rourke will have to include the $50,000 principal amount of the loan in her Net Income For Tax Purposes in 2019. She owns more than 10 percent of the shares, making her a specified employee. This means that she does not qualify for the exception under ITA 15(2.4)(a). While she is an employee, it is unlikely that this type of loan would be generally available to all employees and, as a consequence, it is likely that she received the loan because of her position as a shareholder. This means that she does not qualify for the acquisition of an automobile exception under ITA 15(2.4)(d). If the loan is included in income, she will be entitled to a $50,000 deduction under ITA 20(1)(j) when she repays the loan in 2023.

In the unlikely event that the loan is not included in income and ITA 15(2) does not apply, she will have to include imputed interest at the prescribed rate for the period of the loan. Her shareholder benefit for 2019 is $500 [(2% - Nil)($50,000)(6/12)]. The imputed interest rate and benefit will vary as the prescribed rate changes. Note, however, if imputed interest is assessed, some portion of the amount may be deductible as it relates to the acquisition of an automobile to be used in employment duties.

### *Exercise Fifteen - 7 Solution*

If the loan is repaid on January 1, 2020, it will not be included in two consecutive Generic Inc. Balance Sheets. As a consequence, the principal amount will not have to be included in Ms. Fisk's income. However, as it is an interest-free loan, she will be assessed with a taxable benefit on the loan. The amount would be $1,890 [($162,000)(2% - Nil)(7/12)].

If the loan is not repaid until December 31, 2020, it will appear in two consecutive Generic Inc. Balance Sheets. This means the $162,000 in principal will have to be included in Ms. Fisk's income for the taxation year ending December 31, 2019. However, there will be no imputed interest benefit based on the loan's low rate of interest. In addition, when the loan is repaid, the payment can be deducted from Ms. Fisk's Net Income For Tax Purposes for the taxation year ending December 31, 2020.

### *Exercise Fifteen - 8 Solution*

Mr. Hasid will repay 25 percent of the loan, or $30,750 on October 31, 2020. This will leave an outstanding balance of $92,250 ($123,000 - $30,750) until October 31, 2021.

**If Granted As Employee** Provided Mr. Hasid receives the loan in his capacity as an employee of Hasid Ltd., the loan is one of the exceptions listed under ITA 15(2). This means that the principal amount will not have to be included in income. However, as the loan is interest free, a taxable benefit will arise. It will be calculated by applying the prescribed rate of 2 percent to the principal of the loan for all periods that it is outstanding.

The amount for 2019 would be $410 [($123,000)(2% - Nil)(2/12)] and $2,358 {[($123,000)(2% - Nil)(10/12)] + [($92,250)(2% - Nil)(2/12)]} for 2020. The taxable benefit calculations for 2021 to 2023 would be calculated in a similar fashion.

**If Granted As Shareholder** If Mr. Hasid cannot claim that he received the loan in his capacity as an employee of Hasid Ltd., $92,250 will be included in his income for 2019. The remaining $30,750 would not be included in income as it will have been repaid before Hasid Ltd.'s second year end. However, this balance will attract an interest benefit of $102.50 [($30,750)(2% - Nil)(2/12)] in 2019, and $512.50 [($30,750)(2% - Nil)(10/12)] in 2020.

As the remaining balance is repaid in 2021 through 2023, the payments can be deducted under ITA 20(1)(j) in the year they are repaid.

### *Exercise Fifteen - 9 Solution*

**(1) Salary Compensation**

If the full $550,000 is paid out as salary, it will be deductible and will reduce the Company's Taxable Income to nil. This means that no corporate taxes will be paid. This salary payment will result in Ms. Broad having Taxable Income of $550,000. Given this, her Tax Payable will be calculated as follows:

| | |
|---|---|
| Tax On First $210,371 (Given) | $ 75,000 |
| Tax On Remaining $339,629 ($550,000 - $210,371) At 51% | 173,211 |
| Tax Payable Before Credits | $248,211 |
| Personal Tax Credits (Given) | ( 5,000) |
| Total Tax Payable | $243,211 |

Based on the preceding Tax Payable, Ms. Broad's after tax retention would be $306,789 ($550,000 - $243,211), ignoring CPP contributions and the Canada employment credit.

**(2) Dividend Compensation**

As dividends are not deductible for tax purposes, corporate taxes will have to be paid prior to the payment of any dividends. While the $50,000 of income in excess of the annual business limit of $500,000 would not get the small business deduction, it would be eligible for the general rate reduction of 13 percent. Given this, the corporate rate on this income would be 29% (38% - 10% - 13% + 14%). On income eligible for the small business deduction, the rate would be 12% (38% - 10% - 19% + 3%). Using these rates, corporate taxes would be calculated as follows:

| | |
|---|---|
| Income Not Eligible For SBD [(29%)($50,000)] | $14,500 |
| Income Eligible For SBD [(12%)($500,000)] | 60,000 |
| Corporate Tax Payable | $74,500 |

After payment of these taxes, the maximum dividend that could be paid would be $475,500 ($550,000 - $74,500). The fact that the corporation's Taxable Income was in excess of the annual business limit of $500,000 will create an addition to the GRIP of $36,000 [(72%)($550,000 - $500,000)]. Given this, $36,000 of the dividend can be designated as eligible, leaving a non-eligible dividend of $439,500 ($475,500 - $36,000). The grossed up taxable dividends would be calculated as follows:

| | |
|---|---|
| Total Eligible And Non-Eligible Dividends Received | $475,500 |
| Gross Up: | |
| Eligible Dividends [(38%)($36,000)] | 13,680 |
| Non-Eligible Dividends [(15%)($439,500)] | 65,925 |
| Taxable Dividends | $555,105 |

Personal taxes on this dividend would be calculated as follows:

| | |
|---|---|
| Tax On First $210,371 (Given) | $ 75,000 |
| Federal Tax On Remaining $344,734 ($555,105 - $210,371) At 51% | 175,814 |
| Taxes Payable Before Credits | $250,814 |
| Personal Tax Credits (Given) | ( 5,000) |
| Dividend Tax Credit: | |
| Eligible Dividends [(6/11 + 30%)($13,680)] | ( 11,566) |
| Non-Eligible Dividends [(9/13 + 30%)($65,925)] | ( 65,418) |
| Personal Tax Payable | $168,830 |

The after tax retention would be equal to $306,670 ($475,500 - $168,830). This is $119 less than the after tax retention in the salary option of $306,789.

### *Exercise Fifteen - 10 Solution*

**Required Salary** Ms. Mortell's combined tax rate on additional salary is 45 percent (29% + 16%). In order to have $30,000 in after tax funds, she would have to receive salary of $54,545 [$30,000 ÷ (1 - .45)].

**Required Dividend** Ms. Mortell's tax rate on non-eligible dividends is 37.6 percent [(115%)(45%) - (9/13 + 25%)(15%)]. In order to have $30,000 in after tax funds, she would have to receive dividends of $48,077 [$30,000 ÷ (1 - .376)].

**Tax Cost Of Salary** The net tax cost of paying salary can be calculated as follows:

| | |
|---|---|
| Personal Tax On Receipt Of Salary [(45%)($54,545)] | $24,545 |
| Tax Savings To Corporation [(12%)($54,545)] | ( 6,545) |
| Net Tax Cost Of Salary Alternative | $18,000 |

**Tax Cost Of Dividend** As the dividend payment would not be deductible, its payment would not change corporate taxes. This means that the only tax cost would be the $18,077 [($48,077)(37.6%)] in personal taxes that Ms. Mortell would pay on the dividends received.

**Conclusion** As the tax cost associated with the payment of dividend is slightly larger, the salary alternative would be marginally preferable.

### *Exercise Fifteen - 11 Solution*

**Salary Alternative** - As the available cash is less than Taxable Income, some corporate taxes will have to be paid since there is insufficient cash to pay a salary equivalent to Taxable Income. To determine the maximum salary that can be paid (X), it is necessary to solve the following equation:

$$X = \$18,500 - [(12\%)(\$21,500 - X)]$$

$$X - 0.12X = [\$18,500 - (12\%)(\$21,500)] = \underline{\underline{\$18,091}}$$

| | | |
|---|---|---|
| Corporate Cash Before Taxes | | $18,500 |
| Corporate Taxes [(12%)($21,500 - $18,091)] | | ( 409) |
| Corporate Cash Available For Salary | | $18,091 |
| Salary Received | | $18,091 |
| Personal Tax Payable: | | |
| Personal Tax On Salary [(25%)(18,091)] | ($4,523) | |
| Personal Tax Credits (Given) | 3,950 | ( 573) |
| After Tax Cash Retained | | $17,518 |

**Dividend Alternative** - After tax cash retained with the dividend alternative would be calculated as follows:

| | |
|---|---|
| Corporate Cash Before Taxes | $18,500 |
| Corporate Taxes [(12%)($21,500)] | ( 2,580) |
| Corporate Cash Available For Dividends | $15,920 |
| Non-Eligible Dividend Received | $15,920 |
| Individual Taxes* | Nil |
| After Tax Cash Retained | $15,920 |

*No taxes would be paid on this amount of dividends (see Paragraph 15-86 of the text).

Given these calculations, it is clear that the preferred approach is to pay the maximum salary. Note, however, some combination of dividends and salary may provide an even better result.

## Self Study Solution Fifteen - 1

### *Part A - Goal Of Integration*

The goal of integration is to ensure that the amount of after tax income that an individual receives from a given income source should be the same regardless of whether that income is earned directly, or whether it is flowed through a corporation.

### *Part B - Tax Payable Without Corporation*

Personal Tax Payable without the corporation would be calculated as follows:

| | Business Income | Eligible Dividends |
|---|---|---|
| Income | $80,000 | $ 96,000 |
| Gross Up (38% Of $96,000) | N/A | 36,480 |
| Taxable Income | $80,000 | $132,480 |
| Tax Rate (33% + 18%) | 51% | 51% |
| Tax Payable Before Dividend Tax Credit | $40,800 | $ 67,565 |
| Dividend Tax Credit [(6/11 + 5/11)($36,480)] | N/A | ( 36,480) |
| Personal Tax Payable | $40,800 | $ 31,085 |

The personal Tax Payable if the income is received directly totals $71,885 ($40,800 + $31,085).

### Part C - Corporate Tax Payable

The portfolio dividends would result in Part IV tax of $36,800 [(38-1/3%)($96,000)]. However, this tax would be refunded on the payment of dividends. As a result, the portfolio dividends received of $96,000 would all be available for distribution.

The after tax corporate income available for distribution would be calculated as follows:

| | Business Income | Dividends |
|---|---|---|
| Income | $80,000 | $96,000 |
| Part I Tax [(28% - 19% + 2%)($80,000)] | ( 8,800) | |
| Part IV Tax [(38-1/3%)($96,000)] | | ( 36,800) |
| Available For Dividends | $71,200 | $59,200 |
| Dividend Refund [($59,200 ÷ .616667) - $59,200] | N/A | 36,800 |
| Total Distributable Income | $71,200 | $96,000 |

The amount of the dividend refund would be limited by the balance in the RDTOH accounts. The balance here would reflect the Part IV taxes paid on the portfolio dividends, all of which would be allocated to the Eligible RDTOH. There would be no allocation to the Non-Eligible RDTOH.

At this point, Slater Ltd. has the cash to support a dividend of $167,200 ($71,200 + $96,000), including a refund of $36,800. As all of the $96,000 of portfolio dividends received were allocated to the Company's GRIP account, this amount of dividends can be designated as eligible. The remaining dividends of $71,200 ($167,200 - $96,000), will be non-eligible.

The $36,800 refund would leave the balance in the Company's Eligible RDTOH at nil.

### Part C - Personal Tax Payable

Keith Slater's personal Tax Payable on receipt of the dividend distribution would be calculated as follows:

| | Non-Eligible Dividends | Eligible Dividends |
|---|---|---|
| Eligible Dividends | N/A | $ 96,000 |
| Gross Up At 38 Percent | N/A | 36,480 |
| After Tax ABI As Non-Eligible Dividends | $71,200 | N/A |
| Gross Up At 15 Percent | 10,680 | N/A |
| Taxable Dividends | $81,880 | $132,480 |
| Tax Rate (33% + 18%) | 51% | 51% |
| Tax Payable Before Dividend Tax Credits | $41,759 | $ 67,565 |
| Dividend Tax Credits: | | |
| Eligible Dividends [(6/11 + 5/11)($36,480)] | N/A | ( 36,480) |
| Non-Eligible Dividends [(9/13 + 4/13)($10,680)] | ( 10,680) | N/A |
| Personal Tax Payable | $31,079 | $ 31,085 |

The corporate and personal Tax Payable if Slater Ltd. is used totals $70,964 ($8,800 + $31,079 + $31,085).

### Part D - Comparison Of Results

Comparing the total Tax Payable under the two alternatives provides the following result:

| | |
|---|---|
| Tax Payable - Without Corporation | $71,885 |
| Tax Payable - With Corporation | ( 70,964) |
| Tax Savings With Corporation | $ 921 |

Flowing the income through Slater Ltd. results in a tax savings of $921. By calculating the tax burden on the active business income separately from the dividends, it is clear that there is perfect integration on the portfolio dividends. The Part IV tax paid at the corporate level is totally refunded and the personal taxes paid on the dividends are the same with or without the corporation.

In this example, the Part I corporate rate of 11 percent on the active business income is lower than the 13.04 percent level that is required for perfect integration. In addition, the combined federal/provincial dividend tax credit is equal to the rate required for perfect integration. As a result, there is a tax savings of $921 when the income is flowed through the corporation.

## Self Study Solution Fifteen - 2

### Advantages Of Incorporation

Among the more commonly cited advantages of incorporation would be the following:

**Tax Deferral** It would appear that, if he incorporates, all of the income earned by the corporation will be eligible for the small business deduction. As the corporate rate on this type of income is given as 11 percent, there would be tax deferral on income left within the corporation. As his marginal tax rate as an individual is in the 45 percent range, the amount of the deferral would be significant.

**Tax Reduction** For CCPCs earning active business income, the tax rate required for perfect integration is 13.04 percent. As the relevant corporate rate in his province is 11 percent, this suggests that there would be a tax savings on income flowed through a corporation. However, the provincial dividend tax credit must also be considered. The required rate for perfect integration is 4/13 of the dividend gross up. If the rate in

Gerald's province is below this, the savings resulting from the low corporate rate could be reduced or even eliminated.

**Income Splitting** With a proper structuring of the ownership of the corporation, income can be channeled into the hands of other members of Mr. Copley's family. This can be in the form of either salary or dividends, and will be subject to what we would assume to be significantly lower rates of taxation. We would note, however, that the ability to use this technique may be limited by the application of the Tax On Split Income (TOSI).

**Lifetime Capital Gains Deduction** For 2019, this provision allows for the deduction of up to $866,912 in capital gains. It is available on the disposition of shares in a qualified small business corporation. Properly structured, incorporation could permit all members of his family access to the lifetime capital gains deduction. To qualify, the corporation must be a Canadian controlled private corporation and have at least 90 percent of the fair market value of its assets being used in an active business in Canada. In addition, the shares:

- must not have been owned by anyone other than the taxpayer or a related party for at least 24 months preceding the disposition; and
- throughout this 24 month period, more than 50 percent of the fair market value of the corporation's assets must be used in an active business carried on primarily in Canada.

This deduction could represent a significant advantage of incorporating his business.

**Employee Benefits** While Mr. Copley's organization may be somewhat small to make this feasible, the corporation can be used to establish various retirement programs, as well as group life and health insurance packages.

**Estate Planning** A corporation can be useful in estate planning, particularly with respect to freezing the asset values in the estate (see Chapters 17 and 19).

**Limited Liability** An investor in a corporation is, in general, not liable to the creditors for the debts of the corporation. In the case of large publicly traded corporations this is a very real and important consideration. However, in the case of a small owner-managed business such as Mr. Copley's, it is unlikely that creditors would extend significant sums without getting his personal guarantee for repayment.

However, limited liability could be important if his business is exposed to any type of product liability risk.

**Liquidation Losses** If the business is unsuccessful and must be liquidated, the loss on corporate shares would be deductible as an allowable business investment loss. This means that one-half of the total amount could be deducted against any other income. However, it would require further analysis to ensure that this would involve a greater amount of deductions than would be the case if the business were liquidated in its present unincorporated form.

### *Disadvantages Of Incorporation*

A list of the disadvantages associated with incorporation would include the following:

**Administrative Costs** There will be higher legal, accounting and other costs associated with meeting the various reporting requirements that are necessary for the startup and maintenance of a corporation.

**Losses** The losses of the corporation cannot be offset against other personal income that the shareholders might have. Further, allowable capital losses of corporations can only be deducted against the corporation's taxable capital gains.

**Termination** If the corporation is terminated, there is no available rollover for transferring the assets back to Mr. Copley. Taxation will occur at fair market values. There is a further possibility of double taxation in that, while the corporation will be taxed on the disposition of its assets, the shareholder may be taxed on the same amounts when he disposes of his shares.

**Higher Taxes** Under advantages we noted that there could be a tax reduction associated with a corporation earning income that is eligible for the small business deduction. On the other hand, if the corporation earns income that is not eligible for the small business deduction, there will be a significant extra payment of combined corporate and personal income tax when such income flows through the corporation in the form of dividends to its shareholders.

**Winding Up Procedures** Because of its status as a separate legal entity, the procedures associated with winding up an incorporated business are significantly more complex than those associated with terminating an unincorporated enterprise.

### *Conclusions On Incorporation*

In evaluating the preceding advantages and disadvantages, a recommendation that Mr. Copley incorporate his business seems to be appropriate. He does not appear to need all of the income produced by the business for personal living expenses and, as a consequence, the ability to defer income within the corporation is attractive. Further, his eligibility for the small business deduction could result in a reduction in taxes, even on amounts that are withdrawn from the corporation. Other advantages related to incorporating Mr. Copley's business are the opportunities that may be available to split income between the various members of his family and for estate planning, especially considering the lifetime capital gains deduction.

## Self Study Solution Fifteen - 3

### *Part A - Direct Personal Investment*

Mrs. Martin's marginal tax rate is 46 percent (29% + 17%). If Mrs. Martin invests the $200,000 as an individual, the after tax return can be calculated as follows:

| | |
|---|---|
| Interest Income (All Taxable) | $14,000 |
| | |
| Interest Received | $14,000 |
| Personal Tax Payable At 46 Percent | ( 6,440) |
| After Tax Retention - Direct Receipt | $ 7,560 |

### *Part B - Investment Through Private Company*

If Mrs. Martin invests the $200,000 through her private company, any dividends paid will be non-eligible. The after tax return would be as follows:

| | |
|---|---|
| Interest Income | $14,000 |
| Corporate Taxes At 52 Percent | ( 7,280) |
| Net Corporate Income Before Dividend Refund | $ 6,720 |
| Maximum Dividend Refund (See Note) | 4,177 |
| Maximum Non-Eligible Dividend Payable | $10,897 |
| Gross Up At 15 Percent | 1,635 |
| Taxable Dividend | $12,532 |
| Personal Tax Rate | 46% |
| Personal Tax Payable Before Dividend Tax Credit | $ 5,765 |
| Dividend Tax Credit [(9/13 + 25%)($1,635)] | ( 1,541) |
| Personal Tax Payable | $ 4,224 |

| | |
|---|---|
| Dividends Received | $10,897 |
| Personal Tax Payable | ( 4,224) |
| After Tax Retention - With Corporation | $ 6,673 |

**Note** The Part I refundable taxes on the interest income would be $4,293 [(30-2/3%)($14,000)]. This full amount would be allocated to the Non-Eligible RDTOH balance.

The available corporate cash would support a dividend of $10,897 ($6,720 ÷ .61667, including a dividend refund of $4,177 [(38-1/3%)($10,897)]. As this refund is less than the balance in the Non-Eligible RDTOH, the refund would be limited to $4,177, for a total dividend of $10,897. The refund will leave a balance in the Non-Eligible RDTOH of $116 ($4,293 - $4,177).

As there is no balance in the new Company's GRIP, all of the $10,897 dividend will be non-eligible.

The difference between the two alternatives is $887 ($7,560 - $6,673) in favour of direct personal investment.

## Self Study Solution Fifteen - 4

### *Part A - Direct Personal Investment*

Mr. Martin's marginal tax rate is 46 percent (29% + 17%). If Mr. Martin invests the $200,000 as an individual, the after tax return can be calculated as follows:

| | |
|---|---|
| Eligible Dividends Received | $14,000 |
| 38 Percent Gross Up | 5,320 |
| Taxable Dividend | $19,320 |
| Personal Tax Rate | 46% |
| Personal Tax Payable Before Dividend Tax Credit | $ 8,887 |
| Dividend Tax Credit [(6/11 + 25%)($5,320)] | ( 4,232) |
| Personal Tax Payable | $ 4,655 |

| | |
|---|---|
| Dividends Received | $14,000 |
| Personal Tax Payable | ( 4,655) |
| After Tax Retention - Direct Receipt | $ 9,345 |

***Part B - Investment Through Private Company***

If Mr. Martin invests the $200,000 through his private company, the eligible dividends received would be classified as portfolio dividends, subject to Part IV tax at 38-1/3 percent. There would also be an addition to the corporation's GRIP account of $14,000 (notice that eligible dividends are not multiplied by 72 percent for the GRIP addition). The after tax retention on the flow through the corporation would be as follows:

| | |
|---|---|
| Eligible Dividends Received | $14,000 |
| Part IV Tax At 38-1/3 Percent (Portfolio Dividends) | ( 5,367) |
| Earnings Retained By Corporation | $ 8,633 |
| Refund When Dividends Paid (See Note) | 5,367 |
| Eligible Dividends Paid | $14,000 |

**Note** The available cash would support a dividend of $14,000 ($8,633 ÷ .61667), including a refund of $5,367 [(38-1/3%)($14,000)]. This refund is available as it is equal to the $5,367 balance in the RDTOH resulting from the payment of Part IV tax on the receipt of the dividends.

At this point, the corporation has paid no net amount of taxes and will be paying exactly the same amount of eligible dividends that it received. This will result in Mr. Martin paying exactly the same amount of taxes that he would have paid on direct receipt of the dividends. With the use of a corporation, the after tax retention would be identical to the after tax retention resulting from direct receipt of the dividends.

## Self Study Solution Fifteen - 5

***Approach 1 (Joins Partnership As Individual)***

Cora's share of the partnership income would be $70,000 [(10%)($700,000)]. Cora's Tax Payable resulting from this approach would be calculated as follows:

| | |
|---|---|
| Tax On First $47,630 At 23 Percent (15% + 8%) | $10,955 |
| Tax On Next $22,370 ($70,000 - $47,630) At 32.5 Percent (20.5% + 12%) | 7,270 |
| Tax Payable Before Credits | $18,225 |
| Personal Tax Credits - Given | ( 3,342) |
| Personal Tax Payable | $14,883 |

| | |
|---|---|
| Business Income | $70,000 |
| Personal Tax Payable | ( 14,883) |
| After Tax Retention - Alternative 1 | $55,117 |

***Approach 2 (All Dividends)***

The total corporate taxes would be calculated as follows:

| | |
|---|---|
| First $50,000 At 12 Percent | $ 6,000 |
| Remaining $20,000 At 27 Percent | 5,400 |
| Corporate Tax Payable | $11,400 |

If all of the after tax income is paid out, the resulting dividend will be $58,600 ($70,000 - $11,400).

As $20,000 of the corporation's income was taxed at the general rate, there would be a GRIP balance of $14,400 [(72%)($20,000)]. This means that of the total dividend of $58,600,

$14,400 could be designated as eligible, with the remaining $44,200 ($58,600 - $14,400) being non-eligible. Based on this, Cora's Taxable Income would be as follows:

| | |
|---|---|
| Eligible Dividend | $14,400 |
| Gross Up On Eligible Dividend At 38 Percent | 5,472 |
| Non-Eligible Dividend | 44,200 |
| Gross Up On Non-Eligible Dividend At 15 Percent | 6,630 |
| Total Taxable Income | $70,702 |

Based on this Taxable Income, her Tax Payable would be as follows:

| | |
|---|---|
| Tax On First $47,630 At 23 Percent (15% + 8%) | $10,955 |
| Tax On Remaining $23,072 ($70,702 - $47,630) | |
| At 32.5 Percent (20.5% + 12%) | 7,498 |
| Tax Payable Before Credits | $18,453 |
| Personal Tax Credits - Given | ( 3,342) |
| Dividend Tax Credit = Gross Up ($5,472 + $6,630) | ( 12,102) |
| Personal Tax Payable | $ 3,009 |

| | |
|---|---|
| Business Income | $70,000 |
| Corporate Tax Payable | ( 11,400) |
| Personal Tax Payable | ( 3,009) |
| After Tax Retention - Alternative 2 | $55,591 |

### *Approach 3 (Salary And Dividends)*

With the payment of $20,000 in salaries to reduce corporate income to her $50,000 share of the small business deduction, corporate taxes would be $6,000 [(12%)($50,000)]. This would leave $44,000 ($70,000 - $20,000 - $6,000) for the payment of dividends.

Since no income was taxed at the general rate, the GRIP balance would be nil. This means that the total dividend of $44,000 would be non-eligible. Cora's Taxable Income would be calculated as follows:

| | |
|---|---|
| Salary | $20,000 |
| Non-Eligible Dividend | 44,000 |
| Gross Up On Non-Eligible Dividend At 15 Percent | 6,600 |
| Taxable Income | $70,600 |

Her Tax Payable would be calculated as follows:

| | |
|---|---|
| Tax On First $47,630 At 23 Percent (15% + 8%) | $10,955 |
| Tax On Next $22,970 ($70,600 - $47,630) | |
| At 32.5 Percent (20.5% + 12%) | 7,465 |
| Tax Payable Before Credits | $18,420 |
| Personal Tax Credits - Given | ( 3,342) |
| Dividend Tax Credit = Gross Up | ( 6,600) |
| Personal Tax Payable | $ 8,478 |

| | |
|---|---|
| Business Income | $70,000 |
| Corporate Tax Payable After Salary [(12%)($70,000 - $20,000)] | ( 6,000) |
| Personal Tax Payable | ( 8,478) |
| After Tax Retention - Alternative 3 | $55,522 |

***Evaluation***

The after tax amount retained for each of the three approaches is as follows:

| | |
|---|---|
| Approach 1 (Joins Partnership As Individual) | $55,117 |
| Approach 2 (All Dividends) | 55,591 |
| Approach 3 (Salary And Dividends) | 55,522 |

If only after tax cash flows are considered, Approach 2 provides the highest value and would be the appropriate choice.

Other factors to consider:

- While Approach 2 provides the largest after tax retention, it does not take into consideration CPP contributions. If the effect of CPP was considered, she would pay two times the annual maximum in Approach 1, no CPP in Approach 2 and in Approach 3 both Cora and her corporation would pay less than the annual maximum. Paying CPP contributions would allow her to receive CPP payments in the future, but would incur a liability at the present time. Without going through the required calculations, it is likely that Approach 2 would be best if the required CPP contributions were considered.
- If the Canada employment credit was considered, it would only be applicable in Approach 3.
- If Cora wanted to participate in the Employment Insurance program on a voluntary basis, it would only be available to her in Approach 1 as a self-employed individual.
- If she wanted to contribute to an RRSP or deduct child care costs, she would need earned income. Dividends are not a component of earned income for either purpose. Earned income would be $70,000 in Approach 1 and $20,000 in Approach 3.
- Depending on the province, there could be additional payroll costs that her corporation would have to pay in Approach 3.
- The opportunity for income splitting may be easier with a corporation given that family members could buy shares that entitle them to share in the dividends. This, however, is likely to be limited by the application of the Tax On Split Income (TOSI). Income splitting through the partnership would be much more difficult given that, for the most part, the family members would have to be involved in partnership activity.
- Although an advantage of incorporation is the availability of the lifetime capital gains deduction, given the current situation, it is questionable whether her corporation could be sold for much of a gain given how important her personal services are to its value.

## Self Study Solution Fifteen - 6

***Part A - Tax Payable With Corporation***

The business income of the corporation would be calculated as follows:

| | | |
|---|---|---|
| Management Fees | | $82,900 |
| Expenses: | | |
| Mr. Ashley's Salary | ($18,400) | |
| Office Salaries | ( 25,400) | |
| Office Rent | ( 8,180) | |
| CCA On Office And Dental Equipment | ( 5,700) | |
| Other Business Expenses | ( 2,170) | ( 59,850) |
| Business Income | | $23,050 |
| Rate On Active Business Income | | 11% |
| Tax Payable On Active Business Income | | $ 2,536 |

Tax Payable on the dividends and investment income would be calculated as follows:

| | |
|---|---:|
| Interest Income | $21,600 |
| Net Rental Income ($34,600 - $27,800) | 6,800 |
| Aggregate Investment Income | $28,400 |
| Rate On Investment Income | 51-2/3% |
| Part I Tax On Investment Income | $14,673 |
| Part IV Tax On Dividends Received [(38-1/3%)($13,900)] | 5,328 |
| Tax Payable On Property Income | $20,001 |

The refundable portion of the Part I Tax Payable would be the least of the following amounts:

- $ 8,709 = 30-2/3% Of Aggregate Investment Income [(30-2/3%)($28,400)]
- $ 8,709 = 30-2/3% Of Taxable Income Less Amount Eligible For Small Business Deduction [(30-2/3%)($23,050 + $28,400 - $23,050)]
- $17,209 = Part I Tax Payable ($2,536 + $14,673)

The balances in the two RDTOH accounts would be as follows:

| | |
|---|---:|
| Non-Eligible RDTOH (Part I Refundable Tax) | $8,709 |
| Eligible RDTOH (Part IV Tax Payable) | $5,328 |

The eligible dividends received by the corporation will be added to the GRIP balance, leaving $13,900 in this account (note that the amount received is added, not the amount received multiplied by 72 percent). This means that $13,900 in dividends could be designated as eligible for the enhanced dividend gross up and tax credit procedures.

Given the preceding calculations, the maximum eligible and non-eligible dividend that could be paid is as follows:

| | |
|---|---:|
| Business Income | $23,050 |
| Taxes On Business Income | ( 2,536) |
| Interest Income | 21,600 |
| Net Rental Income | 6,800 |
| Taxes On Property Income | ( 20,001) |
| Eligible Dividends | 13,900 |
| Balance Before Refund | $42,813 |
| Dividend Refund (See Note) | 14,037 |
| Available For Dividends | $56,850 |
| Eligible Dividends (GRIP Balance) | ( 13,900) |
| Non-Eligible Dividends (Remainder) | $42,950 |

**Note** The available cash of $42,813 would support a dividend of $69,426 ($42,813 ÷ 0.61667), including a refund of $26,613 ([(38-1/3%)($69,426)]. However, the actual refund is the lesser of this figure and the $14,037 ($8,709 + $5,328) total of the two RDTOH accounts. Given this, the total dividend is limited to $56,850 ($42,813 + $14,037).

The refund will be deducted from the two RDTOH accounts, leaving each with a balance of nil.

With respect to the eligible dividends, $8,340 [(60%)($13,900)] would go to Mr. Ashley, and

$5,560 [(40%)($13,900)] would go to Dr. Ashley. With respect to the non-eligible dividends, $25,770 [(60%)($42,950)] would go to Mr. Ashley, and $17,180 [40%)($42,950)] would go to Dr. Ashley. The resulting Tax Payable would be as follows:

| | Dr. Ashley | Mr. Ashley |
|---|---|---|
| Salary | Nil | $18,400 |
| Eligible Dividends ($13,900) | $ 5,560 | 8,340 |
| Gross Up At 38 Percent | 2,113 | 3,169 |
| Non-Eligible Dividends ($42,950) | 17,180 | 25,770 |
| Gross Up At 15 Percent | 2,577 | 3,866 |
| Taxable Income | $27,430 | $59,545 |
| Tax Rate | 47% | 30% |
| Tax Payable Before Dividend Tax Credit | $12,892 | $17,864 |
| Dividend Tax Credits: | | |
| Eligible Dividends [(6/11 + 25%)(Gross Up)] | ( 1,681) | ( 2,521) |
| Non-Eligible Dividends [(9/13 + 25%)(Gross Up)] | ( 2,428) | ( 3,643) |
| Tax Payable | $ 8,783 | $ 11,700 |

This would leave after tax balances available to Dr. and Mr. Ashley as follows:

| | |
|---|---|
| Ashley Management Services | Nil |
| Dr. Ashley ($5,560 + $17,180 - $8,783) | $13,957 |
| Mr. Ashley ($18,400 + $8,340 + $25,770 - $11,700) | 40,810 |
| After Tax Retention - Dr. And Mr. Ashley | $54,767 |

***Part B - Balances With No Corporation***

If Dr. Ashley had received all of the amounts involved directly, her Tax Payable and net retention could be calculated as follows:

| | |
|---|---|
| Business Income ($23,050 + $18,400 Salary To Husband) | $41,450 |
| Interest Income | 21,600 |
| Rental Income (Net) | 6,800 |
| Eligible Dividends | 13,900 |
| Gross Up At 38 Percent | 5,282 |
| Taxable Income | $89,032 |
| Tax Rate | 47% |
| Tax Before Dividend Tax Credit | $41,845 |
| Dividend Tax Credit [(6/11 + 25%)($5,282)] | ( 4,202) |
| Tax Payable | $37,643 |

| | |
|---|---|
| Income Received ($41,450 + $21,600 + $6,800 + $13,900) | $83,750 |
| Tax Payable | ( 37,643) |
| After Tax Retention - Dr. Ashley Only | $46,107 |

It is clear from these calculations that the use of the management company has had a positive effect on after tax retention of income. Without the corporation, Dr. Ashley would have ended up with only $46,107. This compares to a total of $54,767 for Mr. and Dr. Ashley when the corporation is used, an improvement of $8,660.

You should note, however, that Dr. Ashley could have paid a salary to her husband without using a corporation. This would have significantly improved the results in Part B.

The problem asked you to ignore personal tax credits, the Canada employment tax credit,

CPP contributions and GST. Personal tax credits would have made only a small difference, as Dr. Ashley would be able to claim the spousal credit in full if Mr. Ashley had no income.

While it is clear the Canada employment tax credit would favour paying Mr. Ashley salary, the advantage or disadvantage of CPP contributions is less clear cut. Although GST is not covered in detail until Chapter 21, we noted in Chapter 12 that the GST/HST legislation has made management companies for GST exempt services such as dentistry less attractive.

## Self Study Solution Fifteen - 7

### *Dwelling Loan*

As such loans are available to all employees, Ms. Lord can claim that she has received the loan in her capacity as an employee. This means that the $200,000 principal does not have to be included in her 2019 Net Income For Tax Purposes. However, as the rate on the loan is below the prescribed rate, there will be a taxable benefit included in Ms. Lord's Net Income For Tax Purposes.

The amount to be accrued for 2019 is $1,000 [($200,000)(2% - 1%)(6/12)]. For 2020, the amount is $1,600 [($200,000 - $40,000)(2% - 1%)(12/12)], and for 2021, the amount is $1,200 [($200,000 - $80,000)(2% - 1%)(12/12)].

### *Automobile*

As there are no bona fide arrangements for repaying the loan, the $25,000 principal amount must be included in Ms. Lord's 2019 Net Income For Tax Purposes. There will be no taxable interest benefit. However, when the loan is repaid, the $25,000 principal amount can be deducted in the determination of Net Income For Tax Purposes.

### *Other Loans*

- **February 1, 2019** As this loan is not repaid prior to August 31, 2020 (the second corporate year end), it has to be included in Ms. Lord's 2019 Net Income For Tax Purposes. In 2021, the year it is repaid, the $35,000 can be deducted from Ms. Lord's Net Income For Tax Purposes. As the loan is included in her income, there will be no benefit associated with the low interest rate. As this result would not be changed if the loan was interest free, paying interest on this loan was not good tax planning.

- **July 1, 2019** As the loan is repaid prior to August 31, 2020 (the second corporate year end), it does not have to be included in Ms. Lord's 2019 Net Income For Tax Purposes. However, as it is interest free, there will be a taxable benefit for imputed interest. For 2019, the amount will be $250 [(2%)($25,000)(6/12)]. For 2020, the benefit will be $333 [(2%)($25,000)(8/12)].

- **December 10, 2019** This loan is repaid prior to its inclusion in a second corporate Balance Sheet. As a consequence, it does not have to be included in income. In addition, as the interest rate of 2 percent on the loan is equal to the prescribed rate, there will be no imputed interest benefit.

## Self Study Solution Fifteen - 8

### *Alternative Treatments*

The tax consequences here will depend on whether the loan was given to Mr. Blaine in his capacity as an employee or, alternatively, in his capacity as a shareholder. Note that this loan would not qualify for a home relocation loan deduction as it can be assumed that the property that he is acquiring is not 40 kilometers closer to his work since the house seller is a neighbour and he bicycles to work.

***Treatment As Shareholder Loan***

If similar loans are not available to the other employees of Blaine Enterprises, it is likely that the CRA will take the view that Mr. Blaine received the loan in his capacity as a shareholder. If this is the case and the loan is included in the Balance Sheet of Blaine Enterprises at two consecutive year ends, the principal amount of the loan will have to be included in Mr. Blaine's Net Income For Tax Purposes in the year of the loan. In this situation, having the company grant the loan has basically the same tax consequences for Mr. Blaine as having the company pay a similar amount of salary. There are, however, several differences:

- When the loan is repaid, the repayment can be deducted under ITA 20(1)(j). In contrast, the receipt of salary cannot be reversed.
- Mr. Blaine's salary of $77,000 does not provide sufficient earned income to allow him to make maximum RRSP contributions. Paying salary would increase his earned income and allow him to make additional RRSP contributions.
- Salary would serve to reduce corporate Tax Payable. While the loan cannot be deducted by Blaine Enterprises in determining Net Income For Tax Purposes, salary payments can be.

Note that since Arthur is receiving a salary of $77,000, he is already eligible for the Canada employment tax credit and paying the maximum CPP contributions so these factors are not relevant.

***Treatment As Employee Loan***

If similar loans are available to the other employees of Blaine Enterprises, Mr. Blaine can argue that he received the loan in his capacity as an employee. Provided there is a reasonable plan for repayment of the loan, he will not have to include the principal amount of the loan in his Net Income For Tax Purposes. However, he would be assessed a taxable benefit in the amount of imputed interest on the outstanding loan balance. The interest rate to be used in this calculation would be the prescribed rate (ITR 4301).

***Evaluation***

If he can claim that he received the loan in his capacity as an employee, the analysis will depend on the relationship between the prescribed rate and the rate that Mr. Blaine would have to pay if he financed his new home with a conventional mortgage. Generally, the prescribed rate tends to be several percentage points below the going rate for mortgages. Based on this, it would appear that if the loan principal can be kept out of his income, having his company provide the loan would be an effective form of tax planning for Mr. Blaine.

If Mr. Blaine is required to include the loan in income because he has received it as a shareholder, it should be determined whether Blaine Enterprises will require the $125,000 in the future. If the intention is to repay the funds, a loan will allow the deduction of the repayment and there will be no taxable benefit for interest. This analysis requires more information about the corporation to determine whether it is more advantageous to have the $125,000 included in Mr. Blaine's income as a shareholder loan or pay salary when both Mr. Blaine and Blaine Enterprises are considered.

## Self Study Solution Fifteen - 9

### Tax Reduction

***Bonus Down***

As salary payments can be deducted by the corporation, the entire $250,000 can be paid as salary since no taxes would be paid by the Company on this amount. Mrs. Litvak's after tax retention would be as follows:

| | |
|---|---|
| Salary Payment | $250,000 |
| Personal Taxes On Salary [(52%)($250,000)] | ( 130,000) |
| After Tax Cash Retained After Bonus Down (2019) | $120,000 |

***No Bonus Down***

If Morcan Inc. does not pay the additional $250,000 in salary, an additional $67,500 [(27%)($250,000)] in corporate taxes would have to be paid. There would also be a $180,000 [(72%)($750,000 - $500,000)] addition to Morcan's GRIP account.

The after tax retention of funds in the corporation would be $182,500 ($250,000 - $67,500). If this amount is paid out as dividends in 2023, $180,000 (the balance in the GRIP account) could be designated as eligible, with the remaining $2,500 classified as non-eligible. Given this, the tax consequences of paying out these dividends would be as follows:

| | |
|---|---|
| Eligible Dividends Received | $180,000 |
| Gross Up At 38 Percent | 68,400 |
| Non-Eligible Dividends Received | 2,500 |
| Gross Up At 15 Percent | 375 |
| Taxable Dividend Paid In 2023 | $251,275 |
| | |
| Tax At 52 Percent [(52%)($251,275] | $130,663 |
| Dividend Tax Credits: | |
| Eligible [(6/11 + 5/11)($68,400)] + | |
| Non-Eligible [(9/13 + 4/13)($375)] | ( 68,775) |
| Personal Tax Cost Of Dividends | $ 61,888 |
| | |
| Dividends Received ($180,000 + $2,500) | $182,500 |
| Personal Tax Cost | ( 61,888) |
| After Tax Cash Retained - No Bonus Down | $120,612 |

***Conclusion***

The difference in after tax retention between the two alternatives is only $612 ($120,612 - $120,000). While this is slightly in favor of bonusing down, the difference is not significant.

## Tax Deferral

If Morcan Inc. pays the salary, there will be an immediate personal tax cost of $130,000. This is more than the $129,388 ($67,500 + $61,888) in taxes that would be paid if she did not bonus down and instead paid corporate taxes on the $250,000 with the remaining funds paid out as dividends in the future. However, Ms. Litvak has indicated that she does not need the additional income and, as a consequence, the payment of the personal taxes can be deferred until 2023. This means the current tax obligation would be limited to the $67,500 in corporate taxes and would constitute a significant tax deferral.

A potential problem with this is the question of whether the corporation can use the additional funds for business purposes. If not, and the funds were allocated to passive investments, the tax rate on investment income could be higher than the 52 percent rate that is applicable on amounts received directly by Ms. Litvak.

## Conclusion

In terms of tax reduction, there is no significant advantage resulting from bonusing down. However, if the retained funds are not paid out as dividends until 2023, there is a significant tax deferral. This would favour not bonusing down. Note that this conclusion is dependent on how the funds will be used within the corporation.

Whether bonusing down will be advantageous will also depend on what use the funds can be put to directly by Mrs. Litvak. If, for example, she has not contributed fully to her RRSP and TFSA and/or her daughter's, bonusing down could be more advantageous.

An added consideration could be how Mrs. Litvak's father might react if she does not take his advice. This could have ramifications for her personally, but should not affect her tax situation.

## Self Study Solution Fifteen - 10

### *Required Salary*

Given Miss Morgan's personal tax rate of 51 percent (33% + 18%), a salary of $40,816 [$20,000 ÷ (1 - .51)] would be required to provide an additional $20,000 of after tax funds.

### *Tax Cost Of Salary Alternative*

The net tax cost of this alternative would be calculated as follows:

| | |
|---|---|
| Personal Taxes On Salary [(51%)($40,816)] | $20,816 |
| Tax Savings To Corporation [(12%)($40,816)] | ( 4,898) |
| Net Tax Cost Of Salary Alternative | $15,918 |

### *Required Dividend*

Miss Morgan's tax rate on non-eligible dividends would be as follows:

[(115%)(51%) - (9/13 + 25%)(15%)] = 44.52%

This gives after tax retention of dividend income in the amount of 55.48 percent (1 - 44.52%). This means a dividend of $36,049 ($20,000 ÷ 55.48%) will be required to provide an additional $20,000 of after tax funds.

### *Tax Cost Of Dividend Alternative*

The personal Tax Payable on the dividend would be calculated as follows:

| | |
|---|---|
| Non-Eligible Dividends Received | $36,049 |
| Gross Up At 15 Percent | 5,407 |
| Taxable Income | $41,456 |
| Tax Rate (33% + 18%) | 51% |
| Tax Payable Before Dividend Tax Credit | $21,143 |
| Dividend Tax Credit [(9/13 + 25%)($5,407)] | ( 5,095) |
| Personal Tax Payable On Dividend Alternative | $16,048 |

Subtracting the Tax Payable of $16,048 from the dividends received of $36,049 gives $20,001 in after tax funds. (The extra $1 is a rounding issue).

As the dividend payment would not be deductible, its payment would not change corporate taxes. This means that the only tax cost would be the $16,048 in personal taxes that Miss Morgan would pay on the dividends received.

### *Conclusion*

The salary alternative has a net tax cost that is $130 ($16,048 - $15,918) lower than the additional tax cost of paying dividends. Given this, the salary alternative would have a marginally lower tax cost.

Since Geraldine has already received a salary of $84,000, CPP contributions and the Canada employment credit are not relevant to this analysis as they would have already been accounted for and would not affect the conclusion.

## Self Study Solution Fifteen - 11

### *Part A - Taxes And Salary*

The combined federal/provincial tax rate applicable to Speelburg Films Ltd. would be 11% (38% - 10% - 19% + 2%).

As the corporation's Taxable Income exceeds the amount of cash available, the maximum amount of salary that can be paid (X) must be determined using the following simple equation:

$$X = \$49,000 - [(11\%)(\$123,000 - X)]$$

Solving this equation for X indicates that the maximum salary that can be paid is $39,854. This can be verified by the following calculation:

| | |
|---|---:|
| Corporate Taxable Income Before Salary | $123,000 |
| Maximum Salary | ( 39,854) |
| Corporate Taxable Income After Salary | $ 83,146 |
| Corporate Rate | 11% |
| Corporate Tax Payable | $ 9,146 |

Payment of this amount of taxes will leave $39,854 ($49,000 - $9,146) available for payment of salary.

With this amount of salary, Mr. Lucas would have the following amount of after tax cash:

| | |
|---|---:|
| Salary Payment | $39,854 |
| Rate (15% + 6%) | 21% |
| Tax Before Credits | $8,369 |
| Personal Tax Credits (Given) | ( 3,900) |
| Personal Tax Payable | $4,469 |
| Salary Received | $39,854 |
| Personal Tax Payable | ( 4,469) |
| After Tax Cash Retained (All Salary) | $35,385 |

### *Part B - All Dividends*

As dividend payments are not deductible to the Company, taxes of $13,530 [(11%)($123,000)] will have to be paid. This leaves a maximum of $35,470 ($49,000 - $13,530) to be used for the payment of non-eligible dividends. When this is paid, the after tax retention by Mr. Lucas will be as follows:

| | |
|---|---:|
| Non-Eligible Dividends Received | $35,470 |
| Gross Up [(15%)($35,470)] | 5,321 |
| Taxable Dividends | $40,791 |
| Personal Tax Rate (15% + 6%) | 21% |
| Tax Payable Before Credits | $ 8,566 |
| Personal Tax Credits (Given) | ( 3,900) |
| Dividend Tax Credit [(9/13 + 30%)($5,321)] | ( 5,280) |
| Tax Payable (Unused Credits = $614) | Nil |

As there is no Tax Payable, Mr. Lucas will retain all of the $35,470 in dividends.

### *Part C - Possible Improvement*

While the Tax Payable for Mr. Lucas is nil in Part B, subtracting personal and dividend tax credits from the tax balance gives a negative figure of $614. This means that the all dividend

approach leaves unused tax credits. While not conclusive, this suggests that there may be a better solution than either all salary or all dividends.

***Part D - Salary/Dividend Combination***

To examine the possibility of an optimum solution using both salary and dividends, consider the result that occurs when $1,000 in salary is paid in lieu of some dividends. Because the deductible salary payment would reduce corporate taxes, dividends would only have to be decreased by $890 [($1,000)(1 - 0.11)]. The tax effects of this switch can be calculated as follows:

| | |
|---|---|
| Increase In Salary | $1,000.000 |
| Decrease In Dividend [($1,000)(1 - .11)] | ( 890.000) |
| Decrease In Dividend Gross Up [(15%)($890.00)] | ( 133.500) |
| Decrease In Mr. Lucas' Taxable Income | ($ 23.500) |
| Personal Tax Rate | 21% |
| Decrease In Tax Payable Before Dividend Tax Credit | ($ 4.935) |
| Decrease In Dividend Tax Credit | |
| = Increase In Tax Payable [(9/13 + 30%)($133.50)] | 132.473 |
| Net Increase In Personal Tax Payable | $ 127.538 |

The rate on a $1,000 increase in salary is 12.7538 percent ($127.538 ÷ $1,000). Applying this rate to the unused credits of $614 (see Part C), gives a required increase in salary of $4,814 ($614 ÷ 0.127538).

Payment of this amount of salary would result in corporate Tax Payable as follows:

| | |
|---|---|
| Corporate Taxable Income Before Salary | $123,000 |
| Salary | ( 4,814) |
| Corporate Taxable Income After Salary | $118,186 |
| Corporate Rate | 11% |
| Corporate Tax Payable | $ 13,000 |

Based on available cash of $49,000, the amount of dividend that could be paid is as follows:

| | |
|---|---|
| Cash Available | $49,000 |
| Corporate Tax Payable | ( 13,000) |
| Salary Payment | ( 4,814) |
| Available For Dividends | $31,186 |

After tax retention at the personal level would be calculated as follows:

| | |
|---|---|
| Non-Eligible Dividends Received | $31,186 |
| Gross Up [(15%)($31,186)] | 4,678 |
| Taxable Dividends | $35,864 |
| Salary | 4,814 |
| Mr. Lucas' Taxable Income | $40,678 |
| Personal Tax Rate (15% + 6%) | 21% |
| Tax Payable Before Credits | $ 8,542 |
| Personal Tax Credits (Given) | ( 3,900) |
| Dividend Tax Credit [(9/13 + 30%)($4,678)] | ( 4,642) |
| Tax Payable | Nil |

| | |
|---|---:|
| Amounts Received ($31,186 + $4,814) | $36,000 |
| Personal Tax Payable | Nil |
| After Tax Cash Retained (Salary And Dividends) | $36,000 |

The comparative results for the three alternatives are as follows:

| | |
|---|---:|
| All Salary | $35,385 |
| All Dividends | $35,470 |
| Salary/Dividend Combination | $36,000 |

The combination of salary and dividends will produce the maximum after tax cash retention for Mr. Lucas. It is a $615 ($36,000 - $35,385) improvement over the all salary solution and a $530 ($36,000 - $35,470) improvement over the all dividend solution.

### *Part E - Other Factors*

Other factors that might be considered include:

- The Canada employment tax credit was ignored in the calculations as it is not a credit against provincial taxes. However, it would allow the first $1,222 of salary to be received with a nil federal tax cost.
- If the effect of CPP was considered, both Mr. Lucas and Speelburg Films Ltd. would pay CPP contributions if salary was paid. Paying CPP contributions would allow him to receive CPP payments in the future, but would require both a personal and a corporate cash outflow at the present time.
- If Speelburg Films Ltd. has benefits for employees, such as a private health services plan, this could make being an employee (by taking salary) more advantageous.
- Dividend payments are not Earned Income for purposes of making RRSP contributions or deducting child care costs.
- If Mr. Lucas has a CNIL balance, dividend payments will serve to reduce this constraint on the lifetime capital gains deduction.
- Mr. Lucas should consider declaring a bonus (a form of salary) to be paid after the end of the calendar year if he does not require the cash immediately. This would defer the personal taxes without affecting corporate taxes as long as the bonus was paid within 180 days of December 31.
- Though not relevant in this problem, some provinces have payroll taxes which could be incurred.

## Chapter 15 Learning Objectives

After completing Chapter 15, you should be able to:

1. Explain how a corporation can be used to reduce taxes, defer taxes, and facilitate income splitting (paragraph [P hereafter] 15-1 to 15-9).
2. Describe other advantages and disadvantages of incorporation (P 15-10 and 15-11).
3. Use various personal and corporate tax rates in the calculation of after-tax retention of earnings flowed through a corporation (P 15-12 to 15-24).
4. Calculate the amount of tax reduction and tax deferral that is available through the use of a public corporation (P 15-25 to 15-34).
5. Calculate the amount of tax reduction and tax deferral that is available through the use of a CCPC earning active business income (P 15-35 to 15-40).

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6. Explain the advantages of bonusing down to the owner of a CCPC eligible for the small business deduction (P 15-41 to 15-45).
7. Calculate the amount of tax reduction and tax deferral that is available through the use of a CCPC earning investment income other than dividends (P 15-46 to 15-49).
8. Calculate the amount of tax reduction and tax deferral that is available through the use of a CCPC earning dividend income (P 15-50 to 15-54).
9. Summarize the tax reduction and tax deferral that is available through the use of various types of corporations earning different types of income (P 15-55 to 15-57).
10. Identify the effect of provincial taxes on the decision to incorporate (P 15-58 to 15-76).

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11. Explain why large amounts of dividends can be received on a tax free basis by individuals with no other source of income (P 15-77 to 15-88).
12. Describe and calculate the benefits that can be achieved by using a corporation to implement income splitting (P 15-89 to 15-91).
13. Determine the tax consequences of various shareholder benefits, including loans (P 15-92 to 15-113).
14. Explain the principles of management compensation in the context of an owner-managed corporation (P 15-114 to 15-120).
15. Describe the basic trade-off between the payment of salary and the payment of dividends for the owner-manager (P 15-121 to 15-127).

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16. Calculate the appropriate choice between salary and dividends, taking into consideration factors other than federal tax savings (P 15-128 to 15-151).
17. Optimize the salary/dividend mix when all tax credits are not utilized or there is a limited amount of cash in the corporation (P 15-152 to 15-168).
18. Summarize the various non-tax factors that must be taken into consideration in making salary vs. dividend decisions (P 15-169 and 15-170).

# CHAPTER 16

## How To Work Through Chapter 16

We recommend the following approach in dealing with the material in this chapter:

**Rollovers Under Section 85 - General Rules For The Transfer**

- Read paragraph 16-1 to 16-30 (in the textbook).

**Transfer Price Rules - Rules Applicable To All Assets**

- Read paragraph 16-31 to 16-36.

**Transfer Price Rules - Accounts Receivable**

- Read paragraph 16-37 to 16-40.

**Transfer Price Rules - Inventories And Non-Depreciable Capital Property**

- Read paragraph 16-41 to 16-49.
- Do Exercise Sixteen-1 (in the textbook) and check the solution in this Study Guide.

**Transfer Price Rules - Non-Depreciable Capital Property**

- Read paragraph 16-50 to 16-61.

**Transfer Price Rules - Depreciable Property**

- Read paragraph 16-62 to 16-69.
- Do Exercise Sixteen-2 and check the solution in this Study Guide.

**Transfer Price Rules - Depreciable Property And Disallowed Terminal Losses**

- Read paragraph 16-70 to 16-73.

**Transfer Price Rules - Eligible Capital Property**

- Read paragraph 16-74.
- Do Self Study Problems Sixteen-1 and 2 and check the solutions in this Study Guide.

**Allocation Of The Elected Value - Consideration Received By The Transferor**

- Read paragraph 16-75 to 16-76.
- Do Exercise Sixteen-3 and check the solution in this Study Guide.

**Allocation Of The Elected Value - Assets Acquired By The Corporation**

- Read paragraph 16-77 to 16-84.

**Paid Up Capital (PUC) Of Shares Issued - General Rules**

- Read paragraph 16-85 to 16-87.

**Paid Up Capital (PUC) Of Shares Issued - Paid Up Capital Reduction**

- Read paragraph 16-88 to 16-92.

### Paid Up Capital (PUC) Of Shares Issued - More Than One Class Of Shares

- Read paragraph 16-93 to 16-96.
- Do Exercise Sixteen-4 and check the solution in this Study Guide.
- Do Self Study Problem Sixteen-3 and check the solution in this Study Guide.

### Comprehensive Example - Section 85 Rollovers

- Read paragraph 16-97 to 16-112.
- Do Exercise Sixteen-5 and check the solution in this Study Guide.
- Do Self Study Problems Sixteen-4, 5, 6, and 7 and check the solutions in this Study Guide.

### Gift To Related Person - Section 85

- Read paragraph 16-113 to 16-127.
- Do Exercise Sixteen-6 and check the solution in this Study Guide.
- Do Self Study Problem Sixteen-8 and check the solution in this Study Guide.

### Excess Consideration - Section 85

- Read paragraph 16-128 to 16-131.
- Do Exercise Sixteen-7 and check the solution in this Study Guide.
- Do Self Study Problem Sixteen-9 and check the solution in this Study Guide.

### Dividend Stripping - ITA 84.1

- Read paragraph 16-132 to 16-149.
- Do Exercise Sixteen-8 and check the solution in this Study Guide.
- Do Self Study Problem Sixteen-10 and check the solution in this Study Guide.

### Capital Gains Stripping - ITA 55(2)

- Read paragraph 16-150 to 16-167.
- Do Exercise Sixteen-9 and check the solution in this Study Guide.
- Do Self Study Problem Sixteen-11 and check the solution in this Study Guide.

### To Complete This Chapter

- If you would like more practice in problem solving, do the Supplementary Self Study Problems for the chapter. These problems and solutions are available on MyLab.
- Review the Key Terms Used In This Chapter in the textbook at the end of Chapter 16. Consult the Glossary for the meaning of any key terms you do not know.
- Test yourself with the Chapter 16 Glossary Flashcards available on MyLab.
- Ensure you have achieved the Chapter 16 Learning Objectives listed in this Study Guide.
- As a review, we recommend you view the PowerPoint presentation for Chapter 16 that is on MyLab.

### Practice Examination

- Write the Practice Examination for Chapter 16 that is on MyLab. Mark your examination using the Practice Examination Solution that is on MyLab.

## Solutions to Chapter Sixteen Exercises

### *Exercise Sixteen - 1 Solution*

**Inventories** The $125,000 amount is both the floor and the ceiling, making this the only possible elected value. The transfer would result in a loss of $15,000 ($140,000 - $125,000), an amount that would be fully deductible as a business loss (ITA 23).

**Land** The floor would be the boot of $150,000 and the ceiling would be the fair market value of $350,000. Electing the minimum amount would result in a taxable capital gain of $20,000 [($150,000 - $110,000)(1/2)].

### *Exercise Sixteen - 2 Solution*

**Class 1 Property** The range would be from a floor of $250,000 (the boot) to a ceiling of $475,000 (fair market value). Election of the $250,000 floor value would result in recapture of $70,000 ($220,000 - $150,000) and a taxable capital gain of $15,000 [($250,000 - $220,000)(1/2)].

**Class 10 Asset** The range would be from a floor of $10,000 (the boot) to a ceiling of $12,000 (fair market value). Electing the minimum value of $10,000 would result in recapture of $2,000 ($10,000 - $8,000).

### *Exercise Sixteen - 3 Solution*

The adjusted cost base amounts would be calculated as follows:

| | |
|---|---|
| Elected Value | $62,000 |
| ACB Of Note (Fair Market Value) | ( 51,000) |
| Available For Shares | $11,000 |
| ACB Of Preferred Shares* | ( 11,000) |
| ACB Of Common Shares (Residual) | Nil |

*Balance available as it is less than the fair market value of $53,000.

### *Exercise Sixteen - 4 Solution*

The adjusted cost base amounts would be calculated as follows:

| | |
|---|---|
| Elected Value | $114,000 |
| ACB Of Note (Fair Market Value) | ( 83,000) |
| Available For Shares | $31,000 |
| ACB Of Preferred Shares* | ( 31,000) |
| ACB Of Common Shares (Residual) | Nil |

*Balance available as it is less than the fair market value of $97,000.

The total PUC reduction would be calculated as follows:

| | | |
|---|---|---|
| Increase In Legal Stated Capital ($97,000 + $54,000) | | $151,000 |
| Less The Excess Of: | | |
| Total Elected Value | ($114,000) | |
| Over The Total Non-Share Consideration | 83,000 | ( 31,000) |
| PUC Reduction | | $120,000 |

Note that this reduction is equal to the deferred gain on the election ($234,000 - $114,000). The PUC reduction would be allocated on the basis of fair market values as follows:

| | |
|---|---|
| Preferred Stock [($120,000)($97,000 ÷ $151,000)] | $ 77,086 |
| Common Stock [($120,000)($54,000 ÷ $151,000)] | 42,914 |
| Total PUC Reduction | $120,000 |

Subsequent to applying this reduction, the remaining PUC of the two classes of shares would be as follows:

| | Preferred Stock | Common Stock |
|---|---|---|
| Legal Stated Capital | $97,000 | $54,000 |
| PUC Reduction (From Preceding) | ( 77,086) | ( 42,914) |
| Total PUC | $19,914 | $11,086 |

Note that the sum of these two figures equals $31,000 ($19,914 + $11,086), the total adjusted cost base of the preferred and common shares, as well as the difference between the elected value of $114,000 and the total non-share consideration of $83,000.

### *Exercise Sixteen - 5 Solution*

**Part 1** The adjusted cost base of all of the consideration will total the elected value of $275,000. It will be allocated as follows:

| | |
|---|---|
| Elected Value | $275,000 |
| Non-Share Consideration ($83,000 + $17,000) | ( 100,000) |
| Adjusted Cost Base Of All Shares | $175,000 |
| Adjusted Cost Base Of Preferred Shares (FMV) | ( 125,000) |
| Adjusted Cost Base Of Common Shares (Residual) | $ 50,000 |

**Part 2** The PUC of the shares issued must be reduced as follows:

| | | |
|---|---|---|
| Increase In Legal Stated Capital ($125,000 + $925,000) | | $1,050,000 |
| Less The Excess Of: | | |
| Elected Value | ($275,000) | |
| Over The Non-Share Consideration | 100,000 | ( 175,000) |
| PUC Reduction | | $ 875,000 |

This PUC reduction would be split between the preferred and common shares on the basis of their fair market values:

| | |
|---|---|
| Preferred Stock [($125,000/$1,050,000)($875,000)] | $104,167 |
| Common Stock [($925,000/$1,050,000)($875,000)] | 770,833 |
| Total PUC Reduction | $875,000 |

Subsequent to applying this reduction, the remaining PUC of the two classes of shares would be as follows:

| | Preferred Stock | Common Stock |
|---|---|---|
| Legal Stated Capital | $125,000 | $925,000 |
| PUC Reduction (From Preceding) | ( 104,167) | ( 770,833) |
| Total PUC | $ 20,833 | $154,167 |

**Part 3** The tax consequences of the preferred stock redemption would be as follows:

| | |
|---|---|
| Proceeds Of Redemption | $125,000 |
| PUC Of The Preferred Shares | ( 20,833) |
| ITA 84(3) Deemed Dividend (Non-Eligible) | $104,167 |

| | |
|---|---|
| Proceeds Of Redemption | $125,000 |
| ITA 84(3) Deemed Dividend | ( 104,167) |
| ITA 54 Deemed Proceeds Of Disposition | $ 20,833 |
| Adjusted Cost Base | ( 125,000) |
| Capital Loss | ($104,167) |
| Inclusion Rate | 1/2 |
| Allowable Capital Loss - Disallowed | ($ 52,084) |

The grossed up non-eligible dividend of $119,792 [(115%)($104,167)] would qualify for a federal dividend tax credit of $10,817 [(9/13)(15%)($104,167)]. The allowable capital loss would be disallowed because the shareholder and the corporation are affiliated.

### Exercise Sixteen - 6 Solution

Using the reassessed fair market value of $110,000, the calculation of the gift is as follows:

| | |
|---|---|
| Fair Market Value Of Property Transferred (Reassessed Value) | $110,000 |
| Less The Greater Of: | |
| • FMV Of Consideration Received = $65,000 ($50,000 + $15,000) | |
| • Elected Amount = $50,000 | ( 65,000) |
| Excess = Gift To Daughter | $ 45,000 |

Given this gift, the tax consequences of the transfer for Ms. Bellows are as follows:

| | |
|---|---|
| Deemed Elected Value = Deemed Proceeds Of Disposition ($50,000 + $45,000 Gift) | $95,000 |
| Adjusted Cost Base | ( 50,000) |
| Capital Gain | $45,000 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain | $22,500 |

The adjusted cost base of her preferred shares would be calculated as follows:

| | |
|---|---|
| Elected Value (Original) | $50,000 |
| Non-Share Consideration | ( 50,000) |
| Adjusted Cost Base Of Preferred Shares | Nil |

As shown in the following calculation, there would be no PUC reduction for the preferred shares issued to Ms. Bellows:

| | | |
|---|---|---|
| Increase In Legal Stated Capital | | $15,000 |
| Less Excess, If Any, Of: | | |
| Deemed Elected Value | ($95,000) | |
| Over Non-Share Consideration | 50,000 | ( 45,000) |
| PUC Reduction | | Nil |

| | |
|---|---|
| PUC Of Preferred Shares ($15,000 - Nil) | $15,000 |

The fair market value of the common shares issued to the daughter is $46,000 ($110,000 Reassessed Value + $1,000 - $50,000 - $15,000).

The sale of the shares for their fair market value would result in the following taxable capital gains:

| | Preferred | Common |
|---|---|---|
| Proceeds (Fair Market Value) | $15,000 | $46,000 |
| Adjusted Cost Base | Nil | ( 1,000) |
| Capital Gain | $15,000 | $45,000 |
| Inclusion Rate | 1/2 | 1/2 |
| Taxable Capital Gain | $ 7,500 | $22,500 |

If the property had simply been sold for its $110,000 post-reassessment fair market value, there would have been a $30,000 [(1/2)($110,000 - $50,000) taxable capital gain. Using ITA 85, Ms. Bellows' total taxable capital gain on the transfer and sale of the preferred shares is also $30,000 ($22,500 + $7,500). However, because the common shares held by the daughter have increased in value by the $45,000 amount of the gift, with their adjusted cost base remaining at $1,000, there is an additional $22,500 taxable capital gain on the sale of her daughter's common shares. This reflects the fact that the $45,000 amount of the gift has been subject to double taxation.

### *Exercise Sixteen - 7 Solution*

On the original transfer in 2018, Larry would have recognized a capital gain of $73,500 [(1/2)($270,000 - $123,000)]. Based on the original estimate of the fair market value of the assets transferred, there was no ITA 15(1) benefit.

With the lower value required by the reassessment, there is excess consideration and an ITA 15(1) benefit.

| | |
|---|---|
| Fair Market Value Of Consideration | $270,000 |
| Reassessed Value Of The Property | ( 217,000) |
| ITA 15(1) Shareholder Benefit | $ 53,000 |

With the value of the property transferred reassessed at $217,000, the elected value cannot exceed this amount. There would be a revised taxable capital gain, calculated as follows:

| | |
|---|---|
| Elected Value Of Property After Reassessment | $217,000 |
| Adjusted Cost Base | ( 123,000) |
| Capital Gain | $ 94,000 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain On Property After Reassessment | $ 47,000 |

As a result of the reassessment, 2018 Net Income For Tax Purposes is increased from $73,500 to $100,000 ($47,000 + $53,000), an increase of $26,500 as shown in the following table:

| | |
|---|---|
| Taxable Capital Gain After Reassessment | $47,000 |
| Shareholder Benefit After Reassessment | 53,000 |
| Reversal Of Reported Taxable Capital Gain | ( 73,500) |
| Total Addition To Net Income For Tax Purposes | $26,500 |

The reason for this increase is that $53,000 of the capital gain, only one-half of which would be taxed, was converted to a 100 percent taxable shareholder benefit of $53,000. The ITA 15(1) benefit of $53,000 would be added to the adjusted cost base of the non-share consideration, resulting in the following adjusted cost base for the non-share consideration:

| | |
|---|---|
| Elected Value | $217,000 |
| ITA 15(1) Shareholder Benefit | 53,000 |
| Adjusted Cost Base Of Non-Share Consideration | $270,000 |

Both the adjusted cost base and the PUC of the preferred shares would be nil.

### *Exercise Sixteen - 8 Solution*

Miss Cole (an individual) has sold shares of a subject corporation to a purchasing corporation, both corporations do not deal with Miss Cole at arm's length, and the two corporations are connected subsequent to the sale. As a consequence, ITA 84.1 is applicable. Given this, the tax consequences of this transaction to Miss Cole are as follows:

| | | |
|---|---|---|
| Increase In Legal Stated Capital | | $317,000 |
| Less Excess, If Any, Of: | | |
| PUC And ACB Of Subject Shares | ($125,000) | |
| Over The Non-Share Consideration | 450,000 | Nil |
| PUC Reduction | | $317,000 |

| | |
|---|---|
| PUC Of New Shares ($317,000 - $317,000) | Nil |

| | | |
|---|---|---|
| Increase In Legal Stated Capital | | $317,000 |
| Non-Share Consideration | | 450,000 |
| Total | | $767,000 |
| Less The Sum Of: | | |
| PUC And ACB Of Subject Shares | ($125,000) | |
| PUC Reduction | ( 317,000) | ( 442,000) |
| ITA 84.1 Deemed Dividend (Non-Eligible) | | $325,000 |

| | |
|---|---|
| Elected Proceeds Of Disposition For Subject Shares | $767,000 |
| ITA 84.1 Deemed Dividend | ( 325,000) |
| Deemed Proceeds For Capital Gains Purposes | $442,000 |
| ACB Of Subject Shares | ( 125,000) |
| Capital Gain | $317,000 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain | $158,500 |

| | |
|---|---|
| ACB Of New Shares ($767,000 - $450,000) | $317,000 |

The grossed up non-eligible dividend of $373,750 [(115%)($325,000)] would qualify for a federal dividend tax credit of $33,750 [(9/13)(15%)($325,000)]. In addition, there would be a taxable capital gain of $158,500 that would be eligible for the lifetime capital gains deduction. If Miss Cole claims the deduction, she may need to pay alternative minimum tax.

**Economic Analysis** Miss Cole is attempting to realize a capital gain of $642,000 ($767,000 - $125,000). However, her non-share consideration was $450,000, $325,000 more than the adjusted cost base of the Cole Inc. shares. ITA 84.1 acts to convert this from a capital gain to a deemed dividend. Note that the remaining $317,000 ($642,000 - $325,000) is allowed to flow through as a capital gain. This reflects the fact that Miss Cole did not attempt to take out the full $767,000 fair market value of the shares in the form of non-share consideration.

### *Exercise Sixteen - 9 Solution*

A deductible dividend has been paid in conjunction with an arm's length sale of shares, and it would appear that the dividend payment served to eliminate the potential capital gain on the transaction. As a consequence, ITA 55 is applicable and the tax consequences of the transaction are as follows:

| | |
|---|---|
| Dividends Received | $750,000 |
| Dividends Attributable To Safe Income (Tax Free) | ( 225,000) |
| Amount Deemed By ITA 55(2)(a) To Not Be A Dividend And By ITA 55(2)(c) To Be A Capital Gain | $525,000 |
| Capital Gain On Sale Of Shares ($90,000 - $75,000) | 15,000 |
| Total Capital Gain | $540,000 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain | $270,000 |

The $225,000 of dividends paid from safe income will retain its status as a dividend and will be deducted in calculating Taxable Income, resulting in no tax cost.

## Self Study Solution Sixteen - 1

### *Part A - No Election*

The disposition of a business is a capital transaction and, in the absence of special provisions, any resulting gain or loss must be treated as a capital gain or loss. With respect to the Inventories, a special provision in ITA 23 indicates that, when such assets are sold as part of the disposition of a business, the sale is deemed to be in the ordinary course of carrying on business and any resulting gain or loss is considered business in nature. ITA 23 automatically applies in the disposition of a business and no election is required on the part of the vendor.

ITA 22 provides for a similar treatment of Accounts Receivable. However, a joint election by the vendor and purchaser is required before this business income treatment is applicable. In the absence of this election, losses on Accounts Receivable are treated as capital losses.

If the assets are transferred at fair market values, the Taxable Income resulting from the transfer can be calculated as follows:

| | |
|---|---|
| Inventories - Business Income ($88,000 - $73,000) | $15,000 |
| Furniture And Fixtures - Recaptured CCA ($45,000 - $38,000) | 7,000 |
| Goodwill [(1/2)($150,000)] | 75,000 |
| Taxable Income | $97,000 |

Note that, with the repeal of the CEC legislation, goodwill is a Class 14.1 asset. Following the usual rules for dispositions of capital assets, the result will be a taxable capital gain of $75,000 [(1/2)($150,000)].

There is also an allowable capital loss of $3,000 [(1/2)($51,000 - $45,000)] on the disposition of the Accounts Receivable. However, it is a superficial loss in that the property is re-acquired within 30 days by an affiliated person (the new corporation would be affiliated with Ms. Flack). ITA 40(2)(g) deems such losses to be nil. This loss would be added to the tax cost of the Accounts Receivable on the corporation's books.

### Part B - ITA 22 And ITA 85 Elections

The cash is not eligible to be transferred under ITA 85, but can be transferred to the corporation without a rollover. All of the other assets can be transferred at elected values under ITA 85. Under the provisions of this Section, the tax consequences would be as follows:

> **Accounts Receivable** If the Accounts Receivable are transferred under ITA 85, the maximum value that can be elected is the fair market value of $45,000. This will result in a capital loss of $6,000 (allowable amount of $3,000). However, this loss will be disallowed under ITA 40(2)(g) because the transfer is to a corporation that will be controlled by Ms. Flack.
>
> **Inventories** The Inventories can be transferred at an elected value of $73,000, resulting in no Taxable Income on the transfer.
>
> **Furniture And Fixtures** The Furniture And Fixtures can be transferred at their UCC of $38,000, resulting in no Taxable Income on the transfer.
>
> **Goodwill** The Goodwill can be transferred at a nominal value of $1, resulting in no significant Taxable Income on the transfer.

An alternative with respect to the Accounts Receivable would be to transfer these assets under the provisions of ITA 22. If Ms. Flack and her corporation were to make this joint election, the $6,000 loss resulting from transferring these assets to the corporation would be fully deductible as a business loss. As it is not a capital loss, it would not be disallowed and Ms. Flack would be able to deduct the full $6,000 against any other source of income in the year of transfer. As ITA 22 is a joint election, the corporation would have to include the $6,000 in income, but could then deduct actual bad debts as they occur. Using the ITA 22 election is the preferable approach to the transfer of these Accounts Receivable.

## Self Study Solution Sixteen - 2

### Part A - Assets To Be Transferred

Of the assets in the Balance Sheet, Cash is not among the eligible assets listed in ITA 85(1.1). This is of no consequence as the tax value of cash is always equal to its carrying value and can be transferred to the corporation without a rollover.

Accounts Receivable could be transferred under Section 85, but are usually transferred to the corporation under the provisions of ITA 22. ITA 22 is used for two reasons. First, it means that any loss on the transfer will be a fully deductible business loss, rather than a capital loss that will be disallowed on a transfer to a corporation controlled by the transferor under ITA 40(2)(g). In addition, the use of the ITA 22 joint election to make the transfer will permit the transferee corporation to deduct any additional bad debts as business losses, rather than capital losses, only one-half of which would be deductible.

There is a potential terminal loss on the transfer of the equipment as the fair market value of the equipment is less than the UCC of the class. Given this, ITA 13(21.2) indicates that ITA 85 does not apply and the proceeds of disposition are deemed to be the UCC amount thereby disallowing the terminal loss.

### Part B - Minimum Transfer Values

The minimum transfer values for the assets to be included in the rollover would be as follows:

| | |
|---|---|
| Inventories (Cost) | $261,000 |
| Land (Adjusted Cost Base) | 196,000 |
| Building (UCC) | 103,600 |
| Equipment (UCC) | 67,000 |
| Goodwill (Nominal Value) | 1 |

**Note** The Goodwill has been given a nominal elected value to ensure that it is specifically included in the transfer. A failure to do this could result in the Goodwill being assessed on the basis of a transfer at fair market value.

### Part C - Tax Consequences

The tax consequences of the asset transfers with respect to both Ms. Speaks and Speaks Inc. can be described as follows:

**Inventories** The cost of the Inventories to Speaks Inc. would be the transfer price of $261,000. As this was the cost of the Inventories, there would be no tax consequence to Ms. Speaks.

**Land** The cost of the Land to Speaks Inc. would be the transfer price of $196,000. As this was the adjusted cost base of the Land, there would be no tax consequence to Ms. Speaks.

**Building** The capital cost of the Building to Speaks Inc. would be $155,500, and Speaks Inc. would be deemed to have taken CCA in the amount of $51,900. As the net value of the transfer is equal to UCC, there would be no tax consequence to Ms. Speaks.

**Equipment** The capital cost of the Equipment to Speaks Inc. would be $222,000, and Speaks Inc. would be deemed to have taken CCA in the amount of $155,000. As the net value of the transfer is equal to UCC, there would be no tax consequence to Ms. Speaks.

**Goodwill** The cost of the Goodwill to Speaks Inc. will be $1. In Ms. Speak's tax records, the proceeds of $1 will be subtracted from Class 14.1, leaving a negative balance in that Class. This amount will be treated as recapture and included in Ms. Speak's income. The $1 will also be added to Class 14.1, restoring the balance to nil. In the Speaks Inc.'s records, the $1 will be added to Class 14.1.

## Self Study Solution Sixteen - 3

## Approach 1

**Immediate Tax Consequences** The $230,000 elected value becomes the proceeds of disposition. As this amount is equal to the adjusted cost base of the land, there are no immediate tax consequences resulting from the transfer.

**ACB Of The Land** The ACB of the land to the corporation would be equal to the elected value of $230,000.

**ACB Of Shares** The ACB of the shares issued by the corporation would be calculated as follows:

| | |
|---|---|
| Elected Value | $230,000 |
| Fair Market Value Of Non-Share Consideration | Nil |
| ACB Of Shares | $230,000 |

**PUC Of Shares** The required PUC reduction and resulting PUC would be calculated as follows:

| | | |
|---|---|---|
| Legal Stated Capital Of Shares | | $660,000 |
| Less Excess, If Any, Of: | | |
| Elected Value | ($230,000) | |
| Over The Non-Share Consideration | Nil | ( 230,000) |
| PUC Reduction | | $430,000 |
| PUC Of Shares ($660,000 - $430,000) | | $230,000 |

## Approach 2

**Immediate Tax Consequences** The elected value of $500,000 becomes proceeds of disposition. As this value exceeds the $230,000 adjusted cost base of the land, there is a taxable capital gain of $135,000 [(1/2)($500,000 - $230,000).

**ACB Of The Land** The ACB of the land to the corporation will be equal to the elected value of $500,000.

**ACB Of Shares** The ACB of the shares issued by the corporation would be calculated as follows:

| | |
|---|---|
| Elected Value | $500,000 |
| Fair Market Value Of Non-Share Consideration | Nil |
| ACB Of Shares | $500,000 |

**PUC Of Shares** The required PUC reduction and resulting PUC would be calculated as follows:

| | | |
|---|---|---|
| Legal Stated Capital Of Shares | | $660,000 |
| Less Excess, If Any, Of: | | |
| Elected Value | ($500,000) | |
| Over The Non-Share Consideration | Nil | ( 500,000) |
| PUC Reduction | | $160,000 |
| PUC Of Shares ($660,000 - $160,000) | | $500,000 |

## Approach 3

**Immediate Tax Consequences** The elected value of $500,000 becomes proceeds of disposition. As this value exceeds the $230,000 adjusted cost base of the land, there is a taxable capital gain of $135,000 [(1/2)($500,000 - $230,000)].

**ACB Of The Land** The ACB of the land to the corporation will be equal to the elected value of $500,000.

**ACB Of Shares** The ACB of the shares issued by the corporation would be calculated as follows:

| | |
|---|---|
| Elected Value | $500,000 |
| Fair Market Value Of Non-Share Consideration | ( 500,000) |
| ACB Of Shares | Nil |

**PUC Of Shares** The required PUC reduction and resulting PUC would be calculated as follows:

| | | |
|---|---|---|
| Legal Stated Capital Of Shares | | $160.000 |
| Less Excess, If Any, Of: | | |
| Elected Value | ($500,000) | |
| Over The Non-Share Consideration | 500,000 | Nil |
| PUC Reduction | | $160,000 |
| PUC Of Shares ($160,000 - $160,000) | | Nil |

## Self Study Solution Sixteen - 4

### *Part A - Adjusted Cost Base Of Consideration*

The adjusted cost base for each item of consideration, under the three alternatives, would be calculated as follows:

| | Alternative One | Alternative Two | Alternative Three |
|---|---|---|---|
| Elected Transfer Price | $225,000 | $225,000 | $225,000 |
| ACB - Boot | ( 150,000) | ( 175,000) | ( 210,000) |
| Available For Preferred And Common Stock | $75,000 | $ 50,000 | $ 15,000 |
| ACB - Preferred Stock | ( 50,000) | ( 50,000) | N/A |
| ACB - Common Stock (Residual) | $ 25,000 | N/A | $ 15,000 |

### *Part B - Legal Stated Capital And PUC*

The legal stated capital for the two classes of shares would be as follows:

| | Alternative One | Alternative Two | Alternative Three |
|---|---|---|---|
| Preferred Stock | $ 50,000 | $450,000 | Nil |
| Common Stock | 425,000 | Nil | $415,000 |
| Total Legal Stated Capital | $475,000 | $450,000 | $415,000 |

The required PUC reduction would be calculated as follows:

| | Alternative One | Alternative Two | Alternative Three |
|---|---|---|---|
| Increase In Legal Stated Capital - All Shares (A) | $475,000 | $450,000 | $415,000 |
| Elected Amount | $225,000 | $225,000 | $225,000 |
| Non-Share Consideration | ( 150,000) | ( 175,000) | ( 210,000) |
| Elected Amount, Less Boot (B) | $ 75,000 | $ 50,000 | $ 15,000 |
| Required PUC Reduction (A - B) | $400,000 | $400,000 | $400,000 |

**Alternative One** In Alternative One, the PUC reduction would have to be split between the two classes of shares on the basis of their relative fair market values. The relevant calculation would be as follows:

Preferred Shares: [($400,000)($50,000 ÷ $475,000)] = $42,105

Common Shares: [($400,000)($425,000 ÷ $475,000)] = $357,895

This would leave a PUC of $7,895 for the preferred shares ($50,000 - $42,105), and a PUC of $67,105 for the common shares ($425,000 - $357,895).

**Alternative Two** In Alternative Two, the entire PUC reduction of $400,000 would be allocated to the preferred shares, leaving a PUC of $50,000 ($450,000 - $400,000).

**Alternative Three** In Alternative Three, the entire PUC reduction of $400,000 would be allocated to the common stock, leaving a PUC of $15,000 ($415,000 - $400,000).

## Self Study Solution Sixteen - 5

### *Part A - ACB Of The Shares*

The adjusted cost base of the shares would be as follows:

| | |
|---|---|
| Total Elected Value | $467,000 |
| Non-Share Consideration ($122,000 + $128,000) | ( 250,000) |
| Adjusted Cost Base Preferred And Common Shares | $217,000 |
| Allocated To Preferred Shares (FMV) | ( 150,000) |
| Adjusted Cost Base Of Common Shares (Residual) | $ 67,000 |

### *Part B - PUC Of The Shares*

The legal stated capital of the preferred and common shares would be their respective fair market values of $150,000 and $326,000. The PUC reduction required under ITA 85(2.1) would be calculated as follows:

| | | |
|---|---|---|
| Increase In Legal Stated Capital ($150,000 + $326,000) | | $476,000 |
| Less Excess Of: | | |
| Total Elected Value | ($467,000) | |
| Over The Total Non-Share Consideration | 250,000 | ( 217,000) |
| Reduction In Paid Up Capital | | $259,000 |

Note that this total reduction is equal to the deferred gain on the election ($726,000 - $467,000). The PUC reduction would be allocated on the basis of fair market values as follows:

| | |
|---|---|
| Preferred Stock [($259,000)($150,000 ÷ $476,000)] | $ 81,618 |
| Common Stock [($259,000)($326,000 ÷ $476,000)] | 177,382 |
| Total PUC Reduction | $259,000 |

Subsequent to applying this reduction, the remaining PUC of the two classes of shares would be as follows:

| | Preferred Shares | Common Shares |
|---|---|---|
| Legal Stated Capital | $150,000 | $326,000 |
| PUC Reduction | ( 81,618) | ( 177,382) |
| PUC | $ 68,382 | $148,618 |

Note that the combined PUC of the two classes of shares is $217,000 ($68,382 + $148,618). This is the same amount as the combined ACB of the two classes of shares ($150,000 + $67,000).

### Part C - Tax Consequences Of Redemption

The tax consequences to Mr. Lardner, if the corporation redeemed both classes of shares at their respective fair market values, would be calculated as follows:

| | Preferred Shares | Common Shares |
|---|---|---|
| Redemption Proceeds | $150,000 | $326,000 |
| PUC (See Preceding Calculations) | ( 68,382) | ( 148,618) |
| ITA 84(3) Deemed Dividend | $ 81,618 | $177,382 |
| Redemption Proceeds | $150,000 | $326,000 |
| ITA 84(3) Deemed Dividend | ( 81,618) | ( 177,382) |
| Deemed Proceeds Of Disposition | $ 68,382 | $148,618 |
| Adjusted Cost Base (Part A) | ( 150,000) | ( 67,000) |
| Capital Gain (Loss) | ($ 81,618) | $ 81,618 |

Mr. Lardner would have a deemed non-eligible dividend of $259,000 ($81,618 + $177,382). The grossed up non-eligible dividend of $297,850 [(115%)($259,000)] would qualify for a federal dividend tax credit of $26,896 [(9/13)(15%)($259,000)]. He has a net capital gain of nil ($81,618 - $81,618).

## Self Study Solution Sixteen - 6

### Part A - Tax Consequences Of Transfer

With respect to the land, the $250,000 elected value will be both the proceeds of disposition to Mr. Bodin and the adjusted cost base to the corporation. As the elected value is equal to Mr. Bodin's adjusted cost base, there will be no tax consequences resulting from the transfer.

The elected value and proceeds of disposition for the building is $750,000, an amount that is less than its capital cost but more than its UCC. This will result in Mr. Bodin having to report recapture of $116,400 ($750,000 - $633,600). The corporation's tax value will be $750,000. However, the corporation will retain the original capital cost of $1,100,000 ($1,350,000 - $250,000) for recapture and capital gains calculations. The $350,000 difference will be deemed to be CCA taken.

### Part B - Adjusted Cost Base Of The Consideration

The adjusted cost base of all consideration received by Mr. Bodin will be the total elected value of $1,000,000 ($250,000 + $750,000). It will be allocated as follow:

| | |
|---|---|
| Total Elected Value | $1,000,000 |
| Total Non-Share Consideration | |
| ($450,000 Assumed Mortgage + $400,000 New Debt) | ( 850,000) |
| Adjusted Cost Base Of Common Shares | $ 150,000 |

#### *Part C - PUC Of The New Shares*

The calculation of PUC would be as follows:

| | | |
|---|---|---|
| Increase In Legal Stated Capital (Fair Market Value) | | $950,000 |
| Less Excess Of: | | |
| Elected Amount | ($1,000,000) | |
| Over The Total Non-Share Consideration | 850,000 | ( 150,000) |
| Reduction In PUC | | $800,000 |

The PUC of the common shares would be reduced to $150,000 ($950,000 - $800,000).

#### *Part D - Sale Of Common Shares*

The increase in Net Income For Tax Purposes from a sale of the shares for $950,000 would be as follows:

| | |
|---|---|
| Proceeds Of Disposition | $950,000 |
| Adjusted Cost Base | ( 150,000) |
| Capital Gain | $800,000 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain | $400,000 |

As Taxable Income consequences are not required, the effect of the lifetime capital gains deduction has not been considered.

#### *Part E - Redemption*

The tax consequences of a redemption for $950,000 would be as follows:

| | |
|---|---|
| Proceeds From Redemption | $950,000 |
| PUC | ( 150,000) |
| ITA 84(3) Deemed Dividend (Non-Eligible) | $800,000 |

There would be no capital gain on this redemption as shown in the following calculation:

| | |
|---|---|
| Redemption Proceeds | $950,000 |
| ITA 84(3) Deemed Dividend | ( 800,000) |
| Deemed Proceeds Of Disposition | $150,000 |
| Adjusted Cost Base | ( 150,000) |
| Capital Gain | Nil |

The amount to be included in Net Income For Tax Purposes would be $920,000, the $800,000 deemed non-eligible dividend grossed up by 15 percent.

There would also be a federal dividend tax credit of $83,077 [(9/13)(15%)($800,000)]. However, as the problem only asks for the amounts to be included in Net Income For Tax Purposes, this is not a required part of the solution.

## Self Study Solution Sixteen - 7

#### *Part A - Assets To Be Transferred And Their Elected Values*

Of the assets in Mr. Danforth's Balance Sheet accounts, Cash and Prepayments are not among the eligible assets listed in ITA 85(1.1). This is of no consequence as the tax value of these assets is generally equal to their carrying values.

The fair market value of the Accounts Receivable is $1,250 ($13,750 - $12,500) less than their face value, reflecting Mr. Danforth's estimate of accounts that will not be collected. While these Accounts Receivable could be transferred under Section 85, they are usually transferred under the provisions of ITA 22. ITA 22 is used for two reasons. First, it means that the $1,250 loss on the transfer will be a fully deductible business loss, rather than a capital loss that will be disallowed on a transfer to a corporation controlled by the transferor. In addition, the use of the ITA 22 joint election will permit the transferee corporation to deduct actual bad debts as they occur as business expenses, rather than as capital losses.

With respect to Inventories, their fair market value and their carrying value are equal. Given this, there is no reason to transfer them under the provisions of Section 85 and they should be sold to Danforth Inc. for their fair market value.

With respect to the Land, there is an unrealized capital loss which will be disallowed on a transfer to an affiliated person. This is the case, without regard to whether Mr. Danforth makes the transfer directly or under the provisions of ITA 85(1). Given this, there is no reason to use ITA 85(1) for this transfer and it should be sold to Danforth Inc. for its fair market value.

There is a potential terminal loss on the transfer of the equipment. Given this, ITA 13(21.2) indicates that ITA 85 does not apply and the proceeds of disposition are deemed to be the UCC amount thereby disallowing the terminal loss.

If we assume that Mr. Danforth chooses to make the ITA 22 election, the following assets will not be transferred under the provisions of ITA 85(1):

| | |
|---|---|
| Cash (Not Eligible) | $ 2,500 |
| Accounts Receivable (ITA 22 Election Used) | 12,500 |
| Inventories (Cost = FMV) | 17,500 |
| Prepayments (Cost = FMV) | 7,500 |
| Land (Disallowed Capital Loss) | 77,500 |
| Equipment (UCC) | 20,000 |
| Total | $137,500 |

In order to minimize capital gains arising on the transfer of proprietorship assets and liabilities to the corporation, the elected price should be the lower of the tax value or the fair market value. The appropriate elected values for the assets that will be transferred using ITA 85 are indicated in the schedule that follows:

| | Tax Values | Fair Market Value | Elected Value |
|---|---|---|---|
| Temporary Investments | $ 27,500 | $ 37,500 | $27,500 |
| Buildings | 70,000 | 125,000 | 70,000 |
| Goodwill (See Note) | Nil | 117,500 | 1 |
| Total Assets Transferred | $97,500 | $280,000 | $97,501 |

**Note** It is prudent to add at least a nominal elected value for goodwill. A failure to do so could result in the application of ITA 69, with the transfer assessed to the transferor at fair market value.

### *Part B - Maximum Non-Share Consideration*

The liabilities that are assumed by the corporation are considered to be a part of the non-share consideration that is received by the transferor. The maximum amount of non-share consideration that can be received by Mr. Danforth on a tax free basis is $97,501. The non-share consideration would be made up of the corporation's assumption of the proprietorship's liabilities of $20,000, plus debt issued by the new corporation in the amount of $77,501.

### *Part C - Capital Gain On Sale Of Shares*

The adjusted cost base of the shares would be nil, as per the following calculation:

| | |
|---|---|
| Elected Value | $97,501 |
| Non-Share Consideration Received | 97,501 |
| Adjusted Cost Base Of Shares | Nil |

Given this, the taxable capital gain on the sale of the shares would be calculated as follows:

| | |
|---|---|
| Proceeds Of Disposition | $208,000 |
| Adjusted Cost Base Of Shares | Nil |
| Capital Gain | $208,000 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain | $104,000 |

Since Danforth Inc. is a qualified small business corporation and Mr. Danforth has no CNIL, the taxable capital gain arising on the disposition of its shares would be eligible for the lifetime capital gains deduction. This means that he will be able to deduct an amount equal to the entire taxable capital gain in calculating his Taxable Income. However, use of his lifetime capital gains deduction to eliminate the taxable capital gain could result in a liability for alternative minimum tax.

## Self Study Solution Sixteen - 8

### *Part A*

The following table shows that the post-reassessment fair market value of the assets transferred to the corporation exceeds the fair market value of the consideration received:

| | |
|---|---|
| Fair Market Value Of Assets Transferred ($1,578,000 + $430,000 - $350,000) | $1,658,000 |
| Less The Greater Of: | |
| • Fair Market Value Of Consideration Received ($160,000 + $947,000 + $471,000) = $1,578,000 | |
| • Elected Value = $1,107,000 | ( 1,578,000) |
| Excess = Gift | $ 80,000 |

As Sarah Cheng is the only common shareholder of the new corporation, it is clear that Mr. Cheng has made a gift to his daughter. As a consequence, the amount of the gift must be added to the elected value in the rollover to arrive at a deemed proceeds of disposition. As the reassessment was on the non-depreciable capital asset land, the result will be a capital gain. This results in the following tax consequences for Mr. Cheng:

| | |
|---|---|
| Deemed Elected Value = Deemed Proceeds Of Disposition ($1,107,000 + $80,000) | $1,187,000 |
| Tax Values Of Assets Transferred | ( 1,107,000) |
| Capital Gain | $ 80,000 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain | $ 40,000 |

The adjusted cost base of the preferred shares received by Mr. Cheng would be calculated as follows:

| | |
|---|---|
| Elected Value (Original) | $1,107,000 |
| Non-Share Consideration ($160,000 + $947,000) | (1,107,000) |
| Adjusted Cost Base Of Preferred Shares | Nil |

The required PUC reduction and resulting PUC would be calculated as follows:

| | | |
|---|---|---|
| Increase In Legal Stated Capital | | $471,000 |
| Excess, If Any, Of: | | |
| Deemed Elected Value | | |
| ($1,107,000 + $80,000) | ($1,187,000) | |
| Over Non-Share Consideration | 1,107,000 | ( 80,000) |
| PUC Reduction | | $391,000 |
| PUC Of Preferred Shares ($471,000 - $391,000) | | $ 80,000 |

***Part B***

The tax consequences to Mr. Cheng of having his shares redeemed would be as follows:

| | |
|---|---|
| Proceeds Of Redemption | $471,000 |
| PUC Of Shares | ( 80,000) |
| ITA 84(3) Deemed Dividend | $391,000 |

| | |
|---|---|
| Proceeds Of Disposition | $471,000 |
| ITA 84(3) Deemed Dividend | ( 391,000) |
| Adjusted Proceeds Of Disposition | $ 80,000 |
| Adjusted Cost Base Of Shares | Nil |
| Capital Gain (Loss) | $ 80,000 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain | $ 40,000 |

This non-eligible deemed dividend would be grossed up to $449,650 [(115%)($391,000)] of Taxable Income and will generate a federal dividend tax credit of $40,604 [(9/13)(15%)($391,000)].

***Part C***

The tax consequences of Sarah selling her shares would be as follows:

| | |
|---|---|
| Proceeds Of Disposition | $90,000 |
| Adjusted Cost Base Of Shares | ( 10,000) |
| Capital Gain | $80,000 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain | $40,000 |

### *Economic Analysis (Not Required)*

If Mr. Cheng had simply sold his business assets for their post reassessment fair market value, he would have had income as in the following calculation:

| | |
|---|---|
| Fair Market Value After Reassessment | |
| ($1,578,000 + $80,000) | $1,658,000 |
| Tax Values Of Assets | ( 1,107,000) |
| Income (Capital Gains And Recapture) | $ 551,000 |

Using the procedures in the problem, the results for Mr. Cheng are as follows:

| | |
|---|---|
| Capital Gain At Transfer | $ 80,000 |
| ITA 84(3) Deemed Dividend | 391,000 |
| Capital Gain On Redemption | 80,000 |
| Total | $551,000 |

While the composition of the income is different, the overall result is the same $551,000 that would have resulted from a simple sale of the listed business assets.

However, there is an impact on Sarah. The $80,000 gift added to the value of her shares with no corresponding increase in the adjusted cost base of the shares. As a result, when she sells the shares, there is a capital gain. In effect, the $80,000 amount of the gift will be subject to double taxation.

Overall, the procedures used in this situation resulted in Mr. Cheng being taxed on the same amount of income as would have been the case without the ITA 85(1) rollover. In addition, Sarah paid taxes on an additional capital gain of $80,000 ($40,000 taxable amount) that would not have occurred if Mr. Cheng had heeded the warnings of his accountant and used a valid fair market value for the land.

## Self Study Solution Sixteen - 9

### *Part A*

The original values used in the transfer resulted in a taxable capital gain of $162,500. Using these values did not indicate any excess consideration. However, with the reassessment value of $650,000 there is an excess, resulting in the following ITA 15(1) benefit:

| | |
|---|---|
| Fair Market Value Of Consideration | $800,000 |
| Reassessed Fair Market Value Of The Property | ( 650,000) |
| ITA 15(1) Shareholder Benefit | $150,000 |

With the value of the transferred property reassessed at $650,000, the elected value cannot exceed this amount. Based on this, there would be a revised taxable capital gain on the transfer, calculated as follows:

| | |
|---|---|
| Elected Value Of Property After Reassessment | $650,000 |
| Adjusted Cost Base | ( 475,000) |
| Capital Gain | $175,000 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain On Property After Reassessment | $ 87,500 |

The net effect of the reassessment would be calculated as follows:

| | |
|---|---|
| Taxable Capital Gain After Reassessment | $ 87,500 |
| Shareholder Benefit After Reassessment | 150,000 |
| Reversal Of Reported Taxable Capital Gain | ( 162,500) |
| Net Addition To Net Income For Tax Purposes | $ 75,000 |

The reason for this increase is that $75,000 ($162,500 - $87,500) of the original taxable capital gain was converted to a 100 percent taxable shareholder benefit of $150,000.

***Part B***

Because a $150,000 benefit will be included in Mel's income as a result of a property acquisition, ITA 52(1) requires that this amount be added to the adjusted cost base of the non-share consideration. Given this, the adjusted cost base of the non-share consideration would be as follows:

| | |
|---|---|
| Revised Elected Value | $650,000 |
| ITA 15(1) Shareholder Benefit | 150,000 |
| Adjusted Cost Base Of Non-Share Consideration | $800,000 |

Both the adjusted cost base and the PUC of the preferred shares issued is nil.

## Self Study Solution Sixteen - 10

***Part A - Tax Consequences Of Proposed Plan***

Ms. Chadwick's plan involves the disposition of shares of a corporation resident in Canada to a corporation with which she does not deal at arm's length (Mr. Borque would be considered Ms. Chadwick's common-law partner.). Subsequent to the transaction, the two corporations are connected (Borque Inc. controls Norton Ltd.). Given these facts, the provisions of ITA 84.1 apply to this transaction.

The required calculations begin with the PUC reduction under ITA 84.1(1)(a):

| | | |
|---|---|---|
| Increase In Legal Stated Capital Of Borque Inc. | | $1,590,000 |
| Less The Excess, If Any, Of: | | |
| Greater Of PUC And ACB Of Norton Ltd. Shares | ($225,000) | |
| Over The Fair Market Value Of The Boot | 875,000 | Nil |
| PUC Reduction | | $1,590,000 |
| PUC After Reduction ($1,590,000 - $1,590,000) | | Nil |

The nil PUC reflects the fact that all of the PUC of the Norton Ltd. shares was taken out as non-share consideration.

The deemed non-eligible dividend under ITA 84.1(1)(b), and federal dividend tax credit, would be calculated as follows:

| | | |
|---|---|---|
| Increase In Legal Stated Capital Of Borque Inc. | | $1,590,000 |
| Fair Market Value Of Boot | | 875,000 |
| Total | | $2,465,000 |
| PUC Of Norton Ltd. Shares | ($ 225,000) | |
| PUC Reduction Under ITA 84.1(1)(a) | ( 1,590,000) | ( 1,815,000) |
| Deemed Dividend Under ITA 84.1(1)(b) | | $ 650,000 |
| Gross Up At 15 Percent | | 97,500 |
| Taxable Non-Eligible Dividend | | $ 747,500 |

| | |
|---|---|
| Federal Dividend Tax Credit [(9/13)(15%)($650,000)] | $ 67,500 |

You will note that, because of the application of ITA 84.1, no capital gain eligible for the lifetime capital gains deduction results from this transaction. This can be seen in the following calculation:

| | |
|---|---|
| Proceeds Before Adjustment Of Norton Shares (Elected Amount) | $875,000 |
| ITA 84.1(1)(b) Deemed Dividend | ( 650,000) |
| Adjusted Proceeds Of Disposition (ITA 54) | $225,000 |
| Adjusted Cost Base Of Shares | ( 225,000) |
| Capital Gain | Nil |

### *Part B - An Improved Solution*

The approach suggested by Ms. Chadwick will not be successful in producing the required $650,000 capital gain. The reason that this approach cannot be successful is that Ms. Chadwick is trying to take out non-share consideration in excess of the $225,000 PUC and ACB of her Norton Ltd. shares. Fortunately, this situation can be corrected by reducing the amount of non-share consideration to $225,000. In conjunction with this reduction in the amount of non-share consideration, the PUC and fair market value of the retractable preferred shares will have to be increased to $2,240,000, so that the total fair market value of the consideration received by Ms. Chadwick equals $2,465,000, the fair market value of the Norton Ltd. shares given up in the transaction. Using this approach, the required PUC reduction under ITA 84.1(1)(b) would be as follows:

| | | |
|---|---|---|
| Increase In Legal Stated Capital Of Borque Inc. | | $2,240,000 |
| Less The Excess, If Any, Of: | | |
| Greater Of PUC And ACB Of Norton Ltd. Shares | ($225,000) | |
| Over The Fair Market Value Of The Boot | 225,000 | Nil |
| PUC Reduction | | $2,240,000 |

| | |
|---|---|
| PUC After Reduction ($2,240,000 - $2,240,000) | Nil |

The deemed non-eligible dividend under ITA 84.1(1)(b) would be calculated as follows:

| | | |
|---|---|---|
| Increase In Legal Stated Capital Of Borque Inc. | | $2,240,000 |
| Fair Market Value Of Boot | | 225,000 |
| Total | | $2,465,000 |
| PUC Of Norton Ltd. Shares | ($ 225,000) | |
| PUC Reduction Under 84.1(1)(b) | ( 2,240,000) | ( 2,465,000) |
| Deemed Dividend Under ITA 84.1(1)(b) | | Nil |

Given the preceding, the capital gain resulting from this transaction is calculated as follows:

| | |
|---|---|
| Proceeds Before Adjustment Of Norton Ltd. Shares (Elected Amount) | $875,000 |
| ITA 84.1(1)(b) Deemed Dividend | Nil |
| Proceeds Of Disposition | $875,000 |
| Adjusted Cost Base Of Norton Ltd. Shares | ( 225,000) |
| Capital Gain | $650,000 |

There would be no tax consequences using this approach, except for the possibility that the alternative minimum tax may be payable. While there would be a $650,000 capital gain, it could be completely eliminated by using Ms. Chadwick's lifetime capital gains deduction.

### *Part C - Sale Of Shares*

As in the other Parts of this question, there is a sale of shares by an individual to a corporation with which the individual is not at arm's length. This means that ITA 84.1 is still applicable.

As no new Borque Inc. shares are issued, no PUC reduction is required.

The ITA 84.1(1)(b) deemed non-eligible dividend would be calculated as follows:

| | | |
|---|---|---|
| Increase In Legal Stated Capital Of Borque Inc. | | Nil |
| Non-Share Consideration Of Shares Sold [(6,530 Shares)($2,465,000 ÷ 22,500)] | | $715,398 |
| Total | | $715,398 |
| PUC Of Norton Ltd. Shares [(6,530 Shares)($10)] | ($65,300) | |
| PUC Reduction Under ITA 84.1(1)(a) | Nil | ( 65,300) |
| Deemed Dividend Under ITA 84.1(1)(b) | | $650,098 |

The taxable non-eligible dividend of $747,613 [(115%)($650,098)] would qualify for a federal dividend tax credit of $67,510 [(9/13)(15%)($650,098)]. Given this deemed dividend, the sale of shares will not result in the desired capital gain. This can be seen in the following calculation:

| | |
|---|---|
| Unadjusted Proceeds Of Disposition [(6,530 Shares)($2,465,000 ÷ 22,500)] | $715,398 |
| Deemed Dividend Under ITA 84.1(1)(b) | ( 650,098) |
| Adjusted Proceeds Of Disposition | $ 65,300 |
| Adjusted Cost Base Of Shares [(6,530 Shares)($10)] | ( 65,300) |
| Capital Gain | Nil |

## Self Study Solution Sixteen - 11

### Part A

In the absence of ITA 55(2), the entire $2,000,000 dividend could be deducted in the determination of Lardley's Taxable Income. However, as a dividend has been paid in conjunction with a disposition of property to an arm's length party, ITA 55(2) is applicable. As a result, the following calculation is required for the dividend received by Lardley:

| | |
|---|---|
| Dividends Received From Domas | $2,000,000 |
| Dividend Attributable To Safe Income (Tax Free) | ( 565,000) |
| Amount Deemed By ITA 55(2)(a) To Not Be A Dividend And By ITA 55(2)(c) To Be A Capital Gain | $1,435,000 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain | $ 717,500 |

As shown, $565,000 of the funds would be received by Lardley as a dividend from safe income and could be deducted under ITA 112, resulting in no tax cost. However, the remainder would be converted to deemed proceeds of disposition, resulting in a taxable capital gain of $717,500.

### Part B

In the absence of ITA 55(2), the results for Lardley would be as follows:

| | |
|---|---|
| Proceeds Of Redemption | $2,300,000 |
| Paid Up Capital Of Preferred Shares | ( 300,000) |
| ITA 84(3) Deemed Dividend | $2,000,000 |

| | |
|---|---|
| Proceeds Of Disposition | $2,300,000 |
| ITA 84(3) Dividend | ( 2,000,000) |
| Adjusted Proceeds Of Disposition | $ 300,000 |
| Adjusted Cost Base | ( 300,000) |
| Capital Gain | Nil |

As the ITA 84(3) dividend can be deducted in the determination of Lardley's Taxable Income, the Company would have succeeded in disposing of the Domas shares without tax consequences.

However, as the redemption was in conjunction with a disposition of the property to an arm's length purchaser, ITA 55(2) alters this result. ITA 55(2)(a) would deem $1,435,000 ($2,000,000, less the Safe Income of $565,000) of the ITA 84(3) dividend to not be a dividend. ITA 55(2)(b) would then deem the $1,435,000 to be proceeds of disposition. The result would be a capital gain determined as follows:

| | |
|---|---|
| Adjusted Proceeds Of Disposition | $ 300,000 |
| Deemed Proceeds Of Disposition | 1,435,000 |
| Total Proceeds Of Disposition | $1,735,000 |
| Adjusted Cost Base | ( 300,000) |
| Capital Gain | $1,435,000 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain | $ 717,500 |

The overall result would be the same as in Part A. That is, a $565,000 tax free dividend and a taxable capital gain of $717,500.

## Chapter 16 Learning Objectives

After completing Chapter 16, you should be able to:

1. Describe the type of situation where ITA 85 is applicable (paragraph [P hereafter] 16-1 to 16-4).
2. Explain the general rules that are applicable to the transferor and the transferee under ITA 85 (P 16-5 to 16-11).
3. Describe the types of consideration that can be received by the transferor under ITA 85 (P 16-12 to 16-14).
4. Describe the procedures required for making the ITA 85 election (P 16-15 to 16-17).
5. Calculate the range of values that can be used in a transfer under the provisions of ITA 85 (P 16-18 to 16-30).

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6. Apply the general rules applicable to all assets that determine the range of values that can be used in a transfer under the provisions of ITA 85 (P 16-31 to 16-36).
7. Apply the detailed rules for the transfer of accounts receivable, inventories, and non-depreciable capital property under ITA 85 (P 16-37 to 16-49).
8. Describe the rules related to the transfer of non-depreciable capital property, including disallowed capital losses on transfers to affiliated persons and the associated tax planning issues (P 16-50 to 16-61).
9. Apply the detailed rules for the transfer of depreciable assets under ITA 85 (P 16-62 to 16-69).
10. Describe the rules related to the disallowance of terminal losses arising on transfers of depreciable capital property to affiliated persons and associated tax planning issues (P 16-70 to 16-73).

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11. Summarize the transfer price rules for all assets under ITA 85 (P 16-74).
12. Calculate the amount of the elected value that will be allocated to each component of the consideration received by the transferor under ITA 85 (P 16-75 and 16-76).
13. Calculate the amount of the elected value that will be allocated to each of the assets acquired by the transferee under ITA 85 (P 16-77 to 16-84).
14. Calculate the Paid Up Capital of the shares received by the transferor in an ITA 85 rollover (P 16-85 to 16-96).
15. Apply the ITA 85 rules to situations involving the incorporation of an unincorporated business (P 16-97 to 16-112).

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16. Identify situations where the ITA 85 rules on gifts to related persons are applicable and make the appropriate adjustments that are required by these rules (P 16-113 to 16-127).
17. Identify situations where the ITA 85 rules on benefits to the transferor are applicable and make the appropriate adjustments that are required by these rules (P 16-128 to 16-131).
18. Identify situations where ITA 84.1 (dividend stripping rules) is applicable (P 16-132 to 16-139).
19. Apply the ITA 84.1 rules to situations involving dividend stripping (P 16-140 to 16-149).
20. Identify situations where ITA 55(2) (capital gains stripping rules) is applicable (P 16-150 to 16-154).
21. Apply the ITA 55(2) rules to situations involving capital gains stripping (P 16-155 to 16-167).

# CHAPTER 17

## How To Work Through Chapter 17

We recommend the following approach in dealing with the material in this chapter:

**Introduction**

- Read paragraph 17-1 to 17-2 (in the textbook).

**Share For Share Exchanges (ITA 85.1)**

- Read paragraph 17-3 to 17-11.
- Do Exercise Seventeen-1 (in the textbook) and check the solution in this Study Guide.
- Read paragraph 17-12 to 17-13.
- Do Self Study Problems Seventeen-1 and Seventeen-2 which are available on MyLab and check the solutions in this Study Guide.

**Exchange Of Shares In A Reorganization (ITA 86)**

- Read paragraph 17-14 to 17-29.
- Do Exercises Seventeen-2 to Seventeen-4 and check the solutions in this Study Guide.
- Do Self Study Problem Seventeen-3 and check the solution in this Study Guide.

**Gift To Related Party - ITA 86(2) (Benefit Rule)**

- Read paragraph 17-30 to 17-40.
- Do Exercise Seventeen-5 and check the solution in this Study Guide.

**Using ITA 86 - Practical Considerations And Tax Planning Considerations**

- Read paragraph 17-41 to 17-46.
- Do Self Study Problems Seventeen-4 and Seventeen-5 and check the solutions in this Study Guide.

**Amalgamations (ITA 87)**

- Read paragraph 17-47 to 17-65.
- Do Exercise Seventeen-6 and check the solution in this Study Guide.

**Winding-Up Of A 90 Percent Owned Subsidiary**

- Read paragraph 17-66 to 17-81.
- Do Exercise Seventeen-7 and check the solution in this Study Guide.
- Read paragraph 17-82 to 17-84.
- Do Exercise Seventeen-8 and check the solution in this Study Guide.
- Read paragraph 17-85 to 17-86.

**Tax Planning Considerations - Amalgamation Vs. Winding-Up**

- Read paragraph 17-87 to 17-93.
- Do Self Study Problem Seventeen-6 and check the solution in this Study Guide.

**Winding-Up Of A Canadian Corporation**

- Read paragraph 17-94 to 17-109.
- Do Exercise Seventeen-9 and check the solution in this Study Guide.
- Do Self Study Problem Seventeen-7 and check the solution in this Study Guide.

**Convertible Properties**

- Read paragraph 17-110 to 17-116.

**Sale Of An Incorporated Business - Assets Vs. Shares**

- Read paragraph 17-117 to 17-155.
- Do Self Study Problem Seventeen-8 and check the solution in this Study Guide.

**To Complete This Chapter**

- If you would like more practice in problem solving, do the Supplementary Self Study Problems for the chapter. These problems and solutions are available on MyLab.
- Review the Key Terms Used In This Chapter in the textbook at the end of Chapter 17. Consult the Glossary for the meaning of any key terms you do not know.
- Test yourself with the Chapter 17 Glossary Flashcards available on MyLab.
- Ensure you have achieved the Chapter 17 Learning Objectives listed in this Study Guide.
- As a review, we recommend you view the PowerPoint presentation for Chapter 17 that is on MyLab.

**Practice Examination**

- Write the Practice Examination for Chapter 17 that is on MyLab. Mark your examination using the Practice Examination Solution that is on MyLab.

## Solutions to Chapter Seventeen Exercises

### *Exercise Seventeen - 1 Solution*

This transaction involves a share for share exchange that meets the conditions of ITA 85.1. Unless Ms. Alee opts out of this rollover provision in her income tax return, the tax consequences of this transaction for Ms. Alee would be as follows:

- Ms. Alee would be deemed to have disposed of her Aayee Ltd. shares at a value equal to their adjusted cost base of $450,000. As a consequence, there would be no capital gain on the disposition.
- Ms. Alee would be deemed to have acquired her Global Outreach Inc. shares at a cost equal to the adjusted cost base of the Aayee Ltd. shares, or $450,000.
- The adjusted cost base of the Aayee Ltd. shares that have been acquired by Global Outreach Inc. would be deemed to be the lesser of their fair market value and their paid up capital. In this case, the $450,000 paid up capital amount is the lower figure.
- The PUC of the Global Outreach Inc. shares that have been issued to Ms. Alee would be $450,000, the PUC of the Aayee Ltd. shares that were given up.

### *Exercise Seventeen - 2 Solution*

The required PUC reduction on the redeemable preferred shares would be calculated as follows:

| | | |
|---|---|---|
| Increase In Legal Stated Capital | | $1,300,000 |
| Less The Excess, If Any, Of: | | |
| PUC Of Common Shares | ($1,000,000) | |
| Over The Non-Share Consideration | 1,000,000 | Nil |
| PUC Reduction | | $1,300,000 |

This means that the redeemable preferred shares would have a PUC of nil ($1,300,000 - $1,300,000).

The adjusted cost base of the redeemable preferred shares would be calculated as follows:

| | |
|---|---|
| Adjusted Cost Base Of Common Shares | $1,000,000 |
| Non-Share Consideration | ( 1,000,000) |
| Adjusted Cost Base Of Redeemable Preferred Shares | Nil |

Because Sam took back cash equal to his PUC and ACB, there would be no ITA 84(3) deemed dividend and no capital gain or loss. These calculations would be as follows:

| | |
|---|---|
| PUC Of New Shares | Nil |
| Plus Non-Share Consideration | $1,000,000 |
| Proceeds Of Redemption Under ITA 84(5)(d) | $1,000,000 |
| PUC Of Old Shares | ( 1,000,000) |
| ITA 84(3) Deemed Dividend | Nil |

| | |
|---|---|
| Adjusted Cost Base Of New Shares | Nil |
| Plus Non-Share Consideration | $1,000,000 |
| Proceeds Of Disposition Under ITA 86(1)(c) | $1,000,000 |
| ITA 84(3) Deemed Dividend | Nil |
| Adjusted Proceeds | $1,000,000 |
| Adjusted Cost Base Of Old Shares | ( 1,000,000) |
| Capital Gain (Loss) | Nil |

### *Exercise Seventeen - 3 Solution*

The required PUC reduction on the redeemable preferred shares would be calculated as follows:

| | | |
|---|---|---|
| Increase In Legal Stated Capital | | $1,300,000 |
| Less The Excess, If Any, Of: | | |
| PUC Of Common Shares | ($1,000,000) | |
| Over The Non-Share Consideration | 1,000,000 | Nil |
| PUC Reduction | | $1,300,000 |

This means that the redeemable preferred shares would have a PUC of nil ($1,300,000 - $1,300,000).

The adjusted cost base of the redeemable preferred shares would be calculated as follows:

| | |
|---|---|
| Adjusted Cost Base Of Common Shares | $1,250,000 |
| Non-Share Consideration | ( 1,000,000) |
| Adjusted Cost Base Of Redeemable Preferred Shares | $ 250,000 |

Because Sam took back cash equal to his PUC and less than his ACB, there would be no ITA 84(3) deemed dividend and no capital gain or loss. These calculations would be as follows:

| | |
|---|---|
| PUC Of New Shares | Nil |
| Plus Non-Share Consideration | $1,000,000 |
| Proceeds Of Redemption Under ITA 84(5)(d) | $1,000,000 |
| PUC Of Old Shares | ( 1,000,000) |
| ITA 84(3) Deemed Dividend | Nil |

| | |
|---|---|
| Adjusted Cost Base Of New Shares | $ 250,000 |
| Plus Non-Share Consideration | 1,000,000 |
| Proceeds Of Disposition Under ITA 86(1)(c) | $1,250,000 |
| ITA 84(3) Deemed Dividend | Nil |
| Adjusted Proceeds | $1,250,000 |
| Adjusted Cost Base Of Old Shares | ( 1,250,000) |
| Capital Gain (Loss) | Nil |

***Exercise Seventeen - 4 Solution***

The required PUC reduction on the redeemable preferred shares would be calculated as follows:

| | | |
|---|---|---|
| Increase In Legal Stated Capital | | $1,100,000 |
| Less The Excess, If Any, Of: | | |
| PUC Of Common Shares | ($1,000,000) | |
| Over The Non-Share Consideration | 1,200,000 | Nil |
| PUC Reduction | | $1,100,000 |

This means that the redeemable preferred shares would have a PUC of nil ($1,100,000 - $1,100,000).

The adjusted cost base of the redeemable preferred shares would be calculated as follows:

| | |
|---|---|
| Adjusted Cost Base Of Common Shares | $1,250,000 |
| Non-Share Consideration | ( 1,200,000) |
| Adjusted Cost Base Of Redeemable Preferred Shares | $ 50,000 |

Because the non-share consideration was greater than the PUC of the old shares, the resulting ITA 84(3) deemed dividend and the allowable capital loss would be calculated as follows:

| | |
|---|---|
| PUC Of New Shares | Nil |
| Plus Non-Share Consideration | $1,200,000 |
| Proceeds Of Redemption Under ITA 84(5)(d) | $1,200,000 |
| PUC Of Old Shares | ( 1,000,000) |
| ITA 84(3) Deemed Dividend (Non-Eligible) | $ 200,000 |

| | |
|---|---|
| Adjusted Cost Base Of New Shares | $ 50,000 |
| Plus Non-Share Consideration | 1,200,000 |
| Proceeds Of Disposition Under ITA 86(1)(c) | $1,250,000 |
| ITA 84(3) Deemed Dividend | ( 200,000) |
| Adjusted Proceeds | $1,050,000 |
| Adjusted Cost Base Of Old Shares | ( 1,250,000) |
| Capital Gain (Loss) | ($ 200,000) |
| Inclusion Rate | 1/2 |
| Allowable Capital Loss | ($ 100,000) |

The taxable amount of the non-eligible dividend would be $230,000 [(115%)($200,000)]. It would qualify for a federal dividend tax credit of $20,769 [(9/13)(15%)($200,000)].

### Exercise Seventeen - 5 Solution

The amount of the gift can be calculated as follows:

| | |
|---|---|
| Fair Market Value Of Shares [(80%)($1,600,000)] | $1,280,000 |
| Consideration Received ($300,000 + $800,000) | ( 1,100,000) |
| Gift To Daughter | $ 180,000 |

As a gift is present in this transaction, ITA 86(2) is applicable.

The PUC reduction on the new shares would be calculated as follows:

| | | |
|---|---|---|
| Increase In Legal Stated Capital | | $800,000 |
| Less The Excess, If Any, Of: | | |
| PUC Of Common Shares [(80%)($250,000)] | ($200,000) | |
| Over The Non-Share Consideration | 300,000 | Nil |
| PUC Reduction | | $800,000 |

This means that the redeemable preferred shares would have a PUC of nil ($800,000 - $800,000).

Under ITA 86(2)(e), the adjusted cost base of the redeemable preferred shares would be calculated as follows:

| | | |
|---|---|---|
| Adjusted Cost Base Of Common Shares | | $200,000 |
| Deduct: | | |
| Non-Share Consideration | ($300,000) | |
| Gift | ( 180,000) | ( 480,000) |
| Adjusted Cost Base Of Preferred Shares | | Nil |

Given the $180,000 gift, the ITA 84(3) deemed dividend and the taxable capital gain would be calculated as follows:

| | |
|---|---|
| PUC Of New Preferred Shares | Nil |
| Plus Non-Share Consideration | $300,000 |
| Proceeds Of Redemption Under ITA 84(5)(d) | $300,000 |
| PUC Of Shares Given Up | ( 200,000) |
| ITA 84(3) Deemed Dividend (Non-Eligible) | $100,000 |

| | |
|---|---|
| Proceeds Of Disposition Under ITA 86(2)(c) - Lesser Of: | |
| • Fair Market Value Of Shares Given Up = $1,280,000 | |
| • Non-Share Consideration Plus Gift ($300,000 + $180,000) = $480,000 | $480,000 |
| Less ITA 84(3) Deemed Dividend | ( 100,000) |
| Adjusted Proceeds | $380,000 |
| Adjusted Cost Base Of Shares Given Up | ( 200,000) |
| Capital Gain | $180,000 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain | $ 90,000 |

The taxable amount of the non-eligible dividend would be $115,000 [(115%)($100,000)]. It would qualify for a federal dividend tax credit of $10,385 [(9/13)(15%)($100,000)].

Her total gain is $280,000 ($100,000 + $180,000). In economic terms this reflects the $100,000 excess of the non-share consideration over the PUC and adjusted cost base of the old shares ($300,000 - $200,000), plus the $180,000 gift. Ms. Reviser would also have a deferred gain of $800,000, the excess of the $800,000 fair market value of the preferred shares over their PUC and adjusted cost base of nil.

The combination of the current and deferred gains is $1,080,000 ($800,000 + $280,000). This is the same amount of gain that would have occurred if Ms. Reviser had simply sold her shares for their fair market value of $1,280,000 ($1,280,000 - $200,000 = $1,080,000).

While this transaction has not changed Ms. Reviser's economic position, it has created an additional taxable amount for her daughter. Before this transaction, the fair market value of the daughter's holding was $320,000 [(20%)($1,600,000)]. This holding now has a value of $500,000. This is the $1,600,000 total value of Janrev Inc. prior to the transaction, less the cash of $300,000, less the fair market value of the preferred shares of $800,000. As there is no increase in her adjusted cost base, this extra $180,000 ($500,000 - $320,000) represents a deferred gain that will be taxed if her shares are redeemed or if she chooses to sell them.

### *Exercise Seventeen - 6 Solution*

As Upton Inc. has a clear majority of the shares in Amalgo Inc., it would appear that they have acquired control of Downer Ltd. As the acquisition of control rules would be applicable, there would be a deemed year end for both Companies that coincides with the amalgamated year end. The non-capital loss carry forward of Downer Ltd. will be flowed through to the amalgamated company, Amalgo Inc. However, because of the acquisition of control, the net capital loss carry forward cannot be used. In addition, the non-capital loss can only be applied against profits earned in the same business or a similar business.

### *Exercise Seventeen - 7 Solution*

Subsequent to an ITA 88(1) winding-up, the parent company can deduct subsidiary losses in its first taxation year beginning after that date. This would be the year beginning on September 16, 2019.

Side's loss is deemed to occur in Park's taxation year that includes Side's year end. This would be the year ending September 15, 2019. This means that it will expire, after 20 taxation years, at the end of Park's taxation year ending September 15, 2039.

### *Exercise Seventeen - 8 Solution*

Under ITA 88(1), a limited bump-up of non-depreciable capital assets is available. The basic limit would be calculated as follows:

| | |
|---|---|
| Adjusted Cost Base Of Lorne Inc. Shares | $1,200,000 |
| Tax Values Of Lorne Inc.'s Net Assets | |
| At Winding-Up ($500,000 - $75,000) | ( 425,000) |
| Dividends Paid By Lorne Since Acquisition | Nil |
| Excess | $ 775,000 |

However, this basic amount cannot exceed the difference between the fair market value of the non-depreciable capital assets at the time of the share acquisition and their tax cost at that time. This amount would be $130,000 ($270,000 - $140,000). The bump-up in the Land value is limited to that amount, resulting in the following tax values for Lorne's assets at the time of the ITA 88(1) winding-up:

| | |
|---|---|
| Cash | $120,000 |
| Land ($140,000 + $130,000) | 270,000 |
| Depreciable Assets - At UCC | 240,000 |
| Total Assets | $630,000 |

Note that the remaining $645,000 ($775,000 - $130,000) of the excess is lost as a result of this wind up.

#### *Exercise Seventeen - 9 Solution*

Given the size of the proceeds, the balance in the combined RDTOH accounts will clearly be less than 38-1/3 percent of the dividends to be declared. Given this, the total distribution to shareholders will be $912,000 ($865,000 + $47,000).

The taxable dividend component of the total distribution to the shareholders is calculated as follows:

| | |
|---|---|
| Total Distribution ($865,000 + $47,000) | $912,000 |
| Paid Up Capital | ( 88,000) |
| ITA 84(2) Deemed Dividend On Winding-Up | $824,000 |
| Capital Dividend Account (Election Required) | ( 26,000) |
| Non-Eligible Dividend Subject To Tax* | $798,000 |

*As the company's GRIP balance is nil, all of the dividends will be non-eligible.

The non-eligible dividend will be grossed up to $917,700 [(115%)($798,000)]. The shareholders will also have a federal dividend tax credit of $82,869 [(9/13)(15%)($798,000)].

As shown in the following calculation, the shareholders will not have a capital gain on the disposition of their shares:

| | |
|---|---|
| Total Distribution To Shareholders | $912,000 |
| ITA 84(2) Deemed Dividend | ( 824,000) |
| Deemed Proceeds Of Disposition | $ 88,000 |
| Adjusted Cost Base Of Shares | ( 88,000) |
| Capital Gain | Nil |

## Self Study Solution Seventeen - 1

#### *Part A - ITA 85.1 Applies*

Jerry elected to transfer his business using ITA 85(1) at a value of $986,000. Given that he took back non-share consideration of $500,000, the adjusted cost base of his Jerry's Flowers common shares would be calculated as follows:

| | |
|---|---|
| Elected Value | $986,000 |
| Non-Share Consideration | ( 500,000) |
| Adjusted Cost Base Of Common Shares | $486,000 |

The PUC of these shares would be calculated as follows:

| | | |
|---|---|---|
| Increase in Legal Stated Capital | | $1,840,000 |
| Less Excess, If Any, Of: | | |
| Elected Value | ($986,000) | |
| Non-Share Consideration | 500,000 | ( 486,000) |
| PUC Reduction | | $1,354,000 |
| PUC Of Common Shares ($1,840,000 - $1,354,000) | | $ 486,000 |

Using these values for the Jerry's Flowers shares, if Jerry does not opt out of ITA 85.1, the tax consequences would be as follows:

- Jerry would be deemed to have disposed of his Jerry's Flowers shares at a value equal to their adjusted cost base of $486,000. Given this, there would be no capital gain on the disposition.
- Jerry would be deemed to have acquired his Large Flowers Inc. shares at a cost equal to the $486,000 adjusted cost base of his Jerry's Flowers shares.
- The PUC of the Large Flowers Inc. shares that have been issued to Jerry would be $486,000, the PUC of the Jerry's Flowers shares that were given up.

### *Part A - Opting Out Of ITA 85.1*

The total fair market value of the Large Flowers shares is $3,750,000. In order to opt out of ITA 85.1, he will have to include a taxable capital gain of $1,632,000 [(1/2)($3,750,000 - $486,000)] in his 2019 tax return. This has the advantage of absorbing his $800,000 net capital loss carry forward. However, it will result in his being required to pay taxes on the remaining $832,000 ($1,632,000 - $800,000). Because all of his shares are involved in the exchange, he has no choice as to the amount of the gain to be recognized.

### *Part B - ACB For Large Flowers Inc.*

The adjusted cost base of the Jerry's Flowers shares in the hands of Large Flowers Inc. would be the lesser of their $3,750,000 fair market value and their PUC. In this case, the PUC amount of $486,000 is lower and will be the adjusted cost base amount.

### *Part C - Alternative Solutions*

There are two possible solutions that would make full use of the $800,000 net capital loss carry forward and minimize the current payment of taxes.

**Alternative One** Jerry could use ITA 85(1) to exchange the shares at an elected value of $2,086,000. If this value was elected, the resulting taxable capital gain would be equal to the required amount of $800,000 [(1/2)($2,086,000 - $486,000)]. Note that this would leave the adjusted cost base of the acquired shares at the elected value of $2,086,000. This compares to $486,000 if ITA 85.1 is used.

**Alternative Two** Each share of Jerry's Flowers Ltd. has a fair market value of $3,750 ($3,750,000 ÷ 1,000) and an adjusted cost base of $486 ($486,000 ÷ 1,000). This means that each share that is sold to Large Flowers would generate a taxable capital gain of $1,632 [(1/2)($3,750 - $486)]. Given this, selling 490 of these shares to Large Flowers would result in a taxable capital gain of $799,680 [(490)($1,632)]. This would be eliminated by the application of the $800,000 net capital loss carry forward. The remaining 510 (1,000 - 490) shares of Jerry's Flowers could then be exchanged for Large Flowers Inc. shares on a tax free basis under either of ITA 85(1) or ITA 85.1.

## Self Study Solution Seventeen - 2

### *Part A - ITA 85.1 Applies*

Sarah elected to transfer her business using ITA 85(1) at a value of $842,000. Given that she took back non-share consideration of $360,000, the adjusted cost base of her Hartman shares would be calculated as follows:

| | |
|---|---|
| Elected Value | $842,000 |
| Non-Share Consideration | ( 360,000) |
| Adjusted Cost Base Of Common Shares | $482,000 |

The PUC of these shares would be calculated as follows:

| | | |
|---|---|---|
| Increase in Legal Stated Capital | | $1,200,000 |
| Less Excess, If Any, Of: | | |
| Elected Value | ($842,000) | |
| Non-Share Consideration | 360,000 | ( 482,000) |
| PUC Reduction | | $ 718,000 |
| PUC Of Common Shares ($1,200,000 - $718,000) | | $ 482,000 |

Using these values for the Hartman shares, if Sarah does not opt out of ITA 85.1, the tax consequences would be as follows:

- Sarah would be deemed to have disposed of her Hartman shares at a value equal to their adjusted cost base of $482,000. Given this, there would be no capital gain on the disposition.
- Sarah would be deemed to have acquired her Grande Ltd. shares at a cost equal to the $482,000 adjusted cost base of her Hartman shares.
- The PUC of the Grande Ltd. shares that have been issued to Sarah would be $482,000, the PUC of the Hartman shares that were given up.

### *Part A - Opting Out Of ITA 85.1*

Sarah can opt out of ITA 85.1 by including a $1,109,000 [(1/2)($2,700,000 - $482,000)] taxable capital gain in her income tax return. This may be desirable in that it will allow her to make use of her $625,000 net capital loss carry forward. However, the disadvantage of opting out of ITA 85.1 is that she will have to pay taxes on the net taxable capital gain of $484,000 ($1,109,000 - $625,000).

Because all of her shares are involved in the exchange, she has no choice as to the amount of the gain to be recognized.

### *Part B - ACB For Grande Ltd.*

The adjusted cost base of the Hartman shares in the hands of Grande would be the lesser of their $2,700,000 fair market value and their PUC. In this case, the PUC amount of $482,000 is lower and will be the adjusted cost base amount.

### *Part C - Alternative Solutions*

There are two possible solutions that would make full use of the $625,000 net capital loss carry forward and minimize the current payment of taxes.

**Alternative One** Sarah could use ITA 85(1) to exchange the shares at an elected value of $1,732,000. If this value was elected, the resulting taxable capital gain would be equal to the required amount of $625,000 [(1/2)($1,732,000 - $482,000)]. Note that this would leave the adjusted cost base of the acquired shares at the elected value of $1,732,000. If ITA 85.1 were used, this value would be the $482,000 PUC of the shares.

**Alternative Two** Each share of Hartman Inc. has a fair market value of $450 ($2,700,000 ÷ 6,000) and an adjusted cost base of $80.33 ($482,000 ÷ 6,000). This means that each share that is sold to Grande would generate a taxable capital gain of $184.84 [(1/2)($450 - $80.33)]. Given this, selling 3,382 of these shares to Grande would result in a taxable capital gain of $625,128.88 [(3,382)($184.84)]. This would be largely eliminated by the application of the $625,000 net capital loss carry forward. The remaining 2,618 (6,000 - 3,382) shares of Hartman could then be exchanged for Grande Ltd. shares on a tax free basis under either of ITA 85(1) or ITA 85.1.

## Self Study Solution Seventeen - 3

The fair market value of the business is $10,985,000 , which is composed of tangible assets of $12,450,000, plus goodwill of $2,000,000, less the bank loan of $3,465,000.

To implement the ITA 86(1) rollover, the twins should each invest $10,000 in exchange for new common shares of BIL.

At this point, Ms. Boswick can exchange, on a tax free basis, her common shares for new preferred shares with a redemption value of $10,985,000. This would have no immediate tax consequences. The ACB and PUC of the new preferred shares would be calculated as follows:

| | | |
|---|---|---|
| Adjusted Cost Base Of Shares Given Up | | $250,000 |
| Non-Share Consideration | | Nil |
| Adjusted Cost Base Of Preferred Shares | | $250,000 |
| | | |
| Legal Stated Capital - Preferred Shares | | $10,985,000 |
| Less Excess, If Any, Of: | | |
| PUC - Shares Given Up | ($250,000) | |
| Non-Share Consideration | Nil | ( 250,000) |
| Required PUC Reduction | | $10,735,000 |
| | | |
| PUC - Preferred Shares ($10,985,000 - $10,735,000) | | $250,000 |

Ms. Boswick's preferred shares will not participate in the future growth of the company. This means that all of the future growth in Boswick Industries will accrue to the two children who are holding the common shares.

In order for Ms. Boswick to retain control, the preferred shares should be voting shares.

Subsequent to these transactions, the July 1, 2019 Balance Sheet would be as follows:

**Boswick Industries Ltd.**
**Shareholders' Equity**
**As At July 1, 2019**

| | |
|---|---|
| Tangible Assets At Tax Values ($12,450,000+ $10,000 + $10,000) | $12,470,000 |
| | |
| Bank Loan | $ 3,465,000 |
| Preferred Shares (Paid Up Capital) | 250,000 |
| Common Shares ($10,000 + $10,000) | 20,000 |
| Retained Earnings | 8,735,000 |
| Total | $12,470,000 |

## Self Study Solution Seventeen - 4

### Part A

**Gift To Jack** This transaction involves a gift of $320,000 to Mr. Mark's son, Jack, calculated as follows:

| | |
|---|---|
| Fair Market Value Of Common Shares Given Up [(80%)($2,400,000)] | $1,920,000 |
| Fair Market Value Of Preferred Shares Received | ( 1,600,000) |
| Gift | $ 320,000 |

It is fair to assume that this amount is a gift to Jack, as he is the only remaining holder of common shares in Markit Ltd.

**PUC Of New Preferred Shares** The PUC reduction required under ITA 86(2.1) would be calculated as follows:

| | | |
|---|---|---|
| Legal Stated Capital Of New Shares | | $8,000 |
| Deduct: | | |
| PUC Of Old Shares | ($8,000) | |
| Non-Share Consideration | Nil | ( 8,000) |
| PUC Reduction | | Nil |
| PUC Of Preferred Shares ($8,000 - Nil) | | $8,000 |

As the required PUC reduction is nil, the PUC of the new shares would be equal to the $8,000 PUC of the old shares.

**Adjusted Cost Base Of New Preferred Shares** This amount would be calculated as follows:

| | | |
|---|---|---|
| Adjusted Cost Base Of Old Shares | | $ 8,000 |
| Deduct: | | |
| Non-Share Consideration | $ Nil | |
| Gift | ( 320,000) | ( 320,000) |
| Adjusted Cost Base Of New Shares | | Nil |

**Proceeds Of Redemption For Old Common Shares - ITA 84(5)(d)** For purposes of determining any ITA 84(3) deemed dividend on the redemption of the old shares, the proceeds of redemption would be as follows:

| | |
|---|---|
| PUC Of New Preferred Shares | $8,000 |
| Non-Share Consideration | Nil |
| Proceeds Of Redemption | $8,000 |

As this amount is equal to the old PUC, there is no ITA 84(3) deemed dividend on the transaction.

**Proceeds Of Disposition For Old Common Shares - ITA 86(2)(c)** For purposes of determining any capital gain on the redemption of the old common shares, the proceeds of disposition would be the lesser of the $1,920,000 fair market value of the old common shares and the following amount:

| | |
|---|---|
| Non-Share Consideration | $ Nil |
| Gift | 320,000 |
| Proceeds Of Disposition | $320,000 |

Using the lesser figure of $320,000, there would be a taxable capital gain on the transaction calculated as follows:

| | |
|---|---|
| Proceeds Of Disposition | $320,000 |
| ITA 84(3) Deemed Dividend | Nil |
| Adjusted Proceeds Of Disposition | $320,000 |
| Adjusted Cost Base | ( 8,000) |
| Capital Gain | $312,000 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain | $156,000 |

The total potential gain on Mr. Mark's shares is $1,912,000 ($1,920,000 - $8,000). Because there was a gift to his son, $312,000 of this amount must be recognized at the time of the roll-over. The remaining $1,600,000 is deferred until the preferred shares are sold or redeemed. In the absence of the gift, all of this gain could have been deferred.

### Part B

This transaction will not alter the total fair market value of the Company and, as a consequence, the value of Jack's common shares will increase by the $320,000 amount of the gift. There will be no corresponding increase in the amount of the tax cost of these shares and, as a consequence, this value will be taxed when Jack sells the common shares. As this value has already been taxed in the hands of Mr. Mark, there will be double taxation on this amount.

### Part C

If Mr. Mark's preferred shares were redeemed at their fair market value of $1,600,000, the tax consequences would be as follows:

| | |
|---|---|
| Redemption Proceeds | $1,600,000 |
| PUC | ( 8,000) |
| ITA 84(3) Deemed Dividend (Non-Eligible) | $1,592,000 |

| | |
|---|---|
| Redemption Proceeds | $1,600,000 |
| Deemed ITA 84(3) Dividend | ( 1,592,000) |
| Adjusted Proceeds Of Disposition | $ 8,000 |
| Adjusted Cost Base | ( Nil) |
| Capital Gain | $ 8,000 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain | $ 4,000 |

The overall tax consequences of the redemption would be as follows:

| | |
|---|---|
| Taxable Dividend [($1,592,000)(115%)] | $1,830,800 |
| Taxable Capital Gain | 4,000 |
| Income Inclusion | $1,834,800 |

The deemed non-eligible dividend would qualify for a federal dividend tax credit of $165,323 [(9/13)(15%)($1,592,000)].

Note that Mr. Mark's dividends and capital gains from the rollover total $1,912,000 ($312,000 + $1,592,000 + $8,000). This is equal to the $1,912,000 [(80%)($2,400,000) - $8,000] capital gain that would have resulted from a sale of his shares at fair market value. From his point of view, the redemption result is less favourable in that part of the gain is in the form of more heavily taxed non-eligible dividends. In addition, if his son were to sell his shares, there would be additional income subject to tax of $320,000.

## Self Study Solution Seventeen - 5

### Approach One - No Gift

#### *Part A*

As the fair market value of the cash and preferred shares ($50,000 + $1,300,000) received by Ms. Platt is equal to the fair market value of the common shares she has given up ($1,350,000), no gift is involved.

#### *Part B*

The paid up capital of the new shares would be reduced as follows:

| | | |
|---|---|---|
| Increase In Legal Stated Capital - New Shares | | $90,000 |
| Less The Excess, If Any, Of: | | |
| PUC - Old Shares [(75%)($120,000)] | ($90,000) | |
| Over Non-Share Consideration | 50,000 | ( 40,000) |
| Reduction In PUC - New Shares | | $50,000 |

Given this reduction, the PUC of the new preferred shares would be as follows:

| | |
|---|---|
| Increase In Legal Stated Capital - New Shares | $90,000 |
| Reduction In PUC | ( 50,000) |
| PUC - New Shares | $40,000 |

#### *Part C*

The adjusted cost base of the preferred shares would be calculated as follows:

| | |
|---|---|
| Adjusted Cost Base - Old Shares [(75%)($120,000)] | $90,000 |
| Non-Share Consideration | ( 50,000) |
| Adjusted Cost Base - New Shares | $40,000 |

#### *Part D*

The Proceeds Of Redemption would be calculated as follows:

| | |
|---|---|
| PUC - New Shares | $40,000 |
| Plus Non-Share Consideration | 50,000 |
| Proceeds Of Redemption [ITA 84(5)(d)] | $90,000 |

The Proceeds Of Disposition would be calculated as follows:

| | |
|---|---|
| Adjusted Cost Base - New Shares | $40,000 |
| Plus Non-Share Consideration | 50,000 |
| Proceeds Of Disposition [ITA 86(1)(c)] | $90,000 |

### Part E Immediate Tax Consequences

As the ITA 84(5)(d) proceeds of redemption are equal to the PUC of the old shares, there is no ITA 84(3) deemed dividend. As the ITA 86(1)(c) proceeds of disposition are equal to the adjusted cost base of the old shares, there is no capital gain. This means there are no immediate tax consequences.

### Part F Tax Consequences Of Redemption Of New Shares

| | |
|---|---|
| Redemption Proceeds | $1,300,000 |
| PUC - New Shares | ( 40,000) |
| ITA 84(3) Deemed Dividend (Non-Eligible) | $1,260,000 |

| | |
|---|---|
| Proceeds Of Disposition | $1,300,000 |
| ITA 84(3) Deemed Dividend | ( 1,260,000) |
| Adjusted Proceeds Of Disposition | $ 40,000 |
| Adjusted Cost Base - Preferred Shares | ( 40,000) |
| Capital Gain | Nil |

The tax consequence would be an income inclusion of $1,449,000 [(115%)($1,260,000)], the grossed up value of the deemed non-eligible dividend. This would qualify for a federal dividend tax credit of $130,846 [(9/13)(15%)($1,260,000)].

### Additional Analysis

While not a required part of the problem, you might wish to note that the $1,260,000 deemed dividend is the same amount of unadjusted income that would have been assessed to Ms. Platt if she had simply sold her shares ($1,350,000 - $90,000). However, it would have been more favourably taxed as a capital gain, rather than as a non-eligible dividend.

## Approach Two - Gift

### Part A

Under this approach, the fair market value of the cash and preferred shares received by Ms. Platt of $1,320,000 ($50,000 + $1,270,000) is less than the fair market value of the common shares she has given up ($1,350,000). As her son is in a residual equity position in PIL, there would appear to be a gift to him in the amount of $30,000 [$1,350,000 - ($50,000 + $1,270,000)]. Given this, ITA 86(2) is applicable.

### Part B

The paid up capital of the preferred shares would be reduced under ITA 86(2.1)(a) as follows:

| | | |
|---|---|---|
| Increase In Legal Stated Capital - New Shares | | $1,270,000 |
| Less The Excess, If Any, Of: | | |
| PUC - Old Shares [(75%)($120,000)] | ($90,000) | |
| Over Non-Share Consideration | 50,000 | ( 40,000) |
| Reduction In PUC - New Shares | | $1,230,000 |

| | |
|---|---|
| Increase In Legal Stated Capital - New Shares | $1,270,000 |
| Reduction In PUC | ( 1,230,000) |
| PUC - New Shares | $ 40,000 |

**Part C**

The adjusted cost base of the preferred shares would be calculated as follows:

| | | |
|---|---|---|
| Adjusted Cost Base - Old Shares | | $90,000 |
| Deduct: | | |
| Non-Share Consideration | ($50,000) | |
| Gift | ( 30,000) | ( 80,000) |
| Adjusted Cost Base - New Shares | | $10,000 |

**Part D**

The Proceeds Of Redemption would be calculated as follows:

| | |
|---|---|
| PUC - New Shares | $40,000 |
| Non-Share Consideration | 50,000 |
| Proceeds Of Redemption [ITA 84(5)(d)] | $90,000 |

The Proceeds Of Disposition would be calculated as follows:

| | |
|---|---|
| Non-Share Consideration | $50,000 |
| Gift | 30,000 |
| Proceeds Of Disposition [ITA 86(2)(c)] | $80,000 |

***Part E Immediate Tax Consequences***

As the ITA 84(5)(d) proceeds of redemption are equal to the PUC of the old shares, there is no ITA 84(3) deemed dividend. However, the ITA 86(2)(c) proceeds of disposition are less than the adjusted cost base of the old shares, resulting in a capital loss of $10,000 ($80,000 - $90,000). This loss would be disallowed by ITA 86(2)(d).

***Part F Tax Consequences Of Redemption***

| | |
|---|---|
| Redemption Proceeds | $1,270,000 |
| PUC - New Shares | ( 40,000) |
| ITA 84(3) Deemed Dividend (Non-Eligible) | $1,230,000 |

| | |
|---|---|
| Proceeds Of Disposition | $1,270,000 |
| ITA 84(3) Deemed Dividend | ( 1,230,000) |
| Adjusted Proceeds Of Disposition | $ 40,000 |
| Adjusted Cost Base - New Shares | ( 10,000) |
| Capital Gain | $ 30,000 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain | $ 15,000 |

The overall tax consequences of the redemption would be as follows:

| | |
|---|---|
| Taxable Dividend [(115%)($1,230,000)] | $1,414,500 |
| Taxable Capital Gain | 15,000 |
| Income Inclusion | $1,429,500 |

The deemed non-eligible dividend would qualify for a federal dividend tax credit of $127,731 [(9/13)(15%)($1,230,000)].

### Additional Analysis

While this analysis is not required by the problem, you might note that the total unadjusted income accruing to Ms. Platt is $1,260,000 ($1,230,000 + $30,000). This is the same total that would have resulted from a sale of her shares [($1,350,000 - $90,000) = $1,260,000]. However, it is received in a less favourable form ($1,230,000 in non-eligible dividends as opposed to all capital gains on a sale of shares). In addition, the market value of her son's shares has increased by the $30,000 amount of the gift. Given that there is no corresponding increase in the adjusted cost base of his shares, this additional amount will be subject to tax if the shares are redeemed or sold.

## Self Study Solution Seventeen - 6

### Use Of Section 87

If ITA 87 is used, the tax consequences are as follows:

- The land will flow through to the amalgamated corporation at its adjusted cost base of $175,000. No capital gain or loss will be recorded.
- As the subsidiary is 100 percent owned, the ITA 88(1) bump-up provision is available. The bump-up will be the lesser of:

| | | |
|---|---|---|
| Adjusted Cost Base Of Lynn Shares | | $390,000 |
| Deduct: | | |
| Lynn's Tax Value For Land - Original Cost | ($175,000) | |
| Dividends Paid By Lynn | Nil | ( 175,000) |
| 1st Value | | $215,000 |
| Value Of Land At Acquisition Of Lynn | | $390,000 |
| Adjusted Cost Base Of Land | | ( 175,000) |
| 2nd Value | | $215,000 |

This will leave the adjusted cost base of the land at $390,000 ($175,000 + $215,000).

### Use Of Section 88(1)

If ITA 88(1) is used, the tax consequences are as follows:

- Lynn will have proceeds of disposition equal to the adjusted cost base of the land of $175,000. No capital gain or loss will be recorded.
- Ricon Ltd. will have the same bump-up on the land as calculated under the ITA 87 approach. The adjusted cost base of the land will also be the same $390,000 that was calculated in the ITA 87 solution.

### Conclusion

Both approaches result in a bump-up of $215,000 and an adjusted cost base for the land of $390,000. It does not appear to make any difference which of the two alternative approaches is used.

## Self Study Solution Seventeen - 7

### *Part A - Funds Available For Distribution*

The taxable capital gains and active business income (recapture) at the corporate level can be calculated as follows:

| Asset | Taxable Capital Gains | Active Business Income |
|---|---|---|
| Inventories | Nil | Nil |
| Taxable Capital Gains: | | |
| On Land [(1/2)($1,243,000 - $623,000)] | $310,000 | Nil |
| On Building [(1/2)($1,173,000 - $775,000)] | 199,000 | |
| Recapture On Building ($775,000 - $586,000) | | $189,000 |
| Totals | $509,000 | $189,000 |

As the active business income is less than the $500,000 annual business limit, there will be no addition to the General Rate Income Pool Balance. The taxable capital gains are not eligible for addition to the GRIP balance.

Taxable Income will be $698,000 ($509,000 + $189,000). Tax Payable on this amount will be calculated as follows:

| | |
|---|---|
| Federal Tax On Business Income [(38% - 10% - 19%)($189,000)] | $ 17,010 |
| Federal Tax On Investment Income [(38% - 10% + 10-2/3%)($509,000)] | 196,813 |
| Part I Tax Payable | $213,823 |
| Provincial Tax On Business Income [(3%)($189,000)] | 5,670 |
| Provincial Tax On Investment Income [(13%)($509,000)] | 66,170 |
| Total Corporate Tax Payable | $285,663 |

### *Non-Eligible RDTOH Balance*

As Kruger's GRIP was nil, all of the opening RDTOH of $27,000 would be allocated to the Non-Eligible RDTOH.

The refundable portion of the Part I tax would be $156,093, the least of:

| | |
|---|---|
| • 30-2/3 Percent Of Investment Income [(30-2/3%)($509,000)] | $156,093 |
| • 30-2/3 Percent Of Taxable Income, Less The Amount Eligible For The Small Business Deduction [(30-2/3%)($698,000 - $189,000)] | $156,093 |
| • Part I Tax Payable | $213,823 |

This amount would be added to the Non-Eligible RDTOH. Based on this, the ending balance in this account would be calculated as follows:

| | |
|---|---|
| Opening Non-Eligible RDTOH | $ 27,000 |
| Refundable Portion Of Part I Tax | 156,093 |
| Ending Non-Eligible RDTOH | $183,093 |

The amount available for distribution to the shareholders, after the payment of taxes at the corporate level, can be calculated as follows:

| | |
|---|---|
| Fair Market Values: | |
| Inventories | $ 35,000 |
| Land | 1,243,000 |
| Building | 1,173,000 |
| Gross Proceeds | $2,451,000 |
| Corporate Tax Payable | ( 285,663) |
| Dividend Refund (Note) | 183,093 |
| Funds Available For Distribution | $2,348,430 |

**Note** Technically, the dividend refund is the lesser of the $183,093 balance in the RDTOH account and 38-1/3 percent of taxable dividends paid. However, given the size of the distribution in this problem, it is clear that $183,093 will be the lower figure.

With respect to the capital dividend account, the final balance is calculated as follows:

| | |
|---|---|
| Balance Before Dispositions | $215,000 |
| Disposition Of Land | 310,000 |
| Disposition Of Building | 199,000 |
| Ending Balance | $724,000 |

### *Part B - Components Of Distribution*

Assuming an election has been made to declare the maximum capital dividend, the taxable dividend component of the total distribution to the shareholders can be calculated as follows:

| | |
|---|---|
| Distribution To Shareholders | $2,348,430 |
| Paid Up Capital | ( 447,000) |
| ITA 84(2) Deemed Dividend | $1,901,430 |
| Capital Dividend (Balance In Account) | ( 724,000) |
| Deemed Dividend Subject To Tax (Non-Eligible) | $1,177,430 |

As Kruger has no GRIP balance, all of this dividend will be non-eligible. The taxable amount will be $1,354,045 [(115%)($1,177,430)]. This dividend will qualify for a federal dividend tax credit of $122,272 [(9/13)(15%)($1,177,430)].

### *Part B - Capital Gain*

With respect to capital gains, ITA 54 indicates that the proceeds of disposition for purposes of determining any capital gain on the disposition of shares does not include any amount paid out as ITA 84(2) dividends. Given the preceding calculation, the capital gain to the shareholders would be calculated as follows:

| | |
|---|---|
| Actual Distribution To Shareholders | $2,348,430 |
| ITA 84(2) Deemed Dividend | ( 1,901,430) |
| Deemed Proceeds Of Disposition | $ 447,000 |
| Adjusted Cost Base For Shares | ( 447,000) |
| Capital Gain | Nil |

## Self Study Solution Seventeen - 8

### Sale Of Assets

This calculation requires two steps. First, we must determine the after tax proceeds that will be available at the corporate level subsequent to the sale of the assets. Then, a second stage analysis is required to determine the amount that will be retained by Mr. Lange after he pays all of the taxes that are due on the proceeds that are distributed to him.

***Cash Proceeds, Capital Gains, And Business Income***

The direct sale of the assets would create the following amounts of cash, taxable capital gains, and business income:

| Asset | Cash Proceeds | Taxable Capital Gains | Active Business Income |
|---|---|---|---|
| Accounts Receivable | | | |
| ($91,000 - $83,000) | $ 91,000 | | $ 8,000 |
| Inventories ($298,000 - $237,000) | 298,000 | Nil | 61,000 |
| Land [(1/2)($656,000 - $167,000)] | 656,000 | 244,500 | |
| Building: | | | |
| [(1/2)($652,000 - $582,000)] | | 35,000 | |
| ($582,000 - $176,000) | 652,000 | | 406,000 |
| Goodwill | 719,000 | 359,500 | Nil |
| Totals For Purchased Assets | $2,416,000 | $639,000 | $475,000 |
| Term Deposits | 529,000 | Nil | Nil |
| Totals | $2,945,000 | $639,000 | $475,000 |

***Taxable Income And Tax Payable***

Taxable Income will total $1,114,000 ($639,000 + $475,000). The Tax Payable on this amount would be calculated as follows:

| | |
|---|---|
| Federal Tax On: | |
| Business Income [(38% - 10% - 19%)($475,000)] | $ 42,750 |
| Investment Income [(38% - 10% + 10-2/3%)($639,000)] | 247,080 |
| Part I Tax Payable | $289,830 |
| Provincial Tax On Business Income [(3%)($475,000)] | 14,250 |
| Provincial Tax On Investment Income [(14%)($639,000)] | 89,460 |
| Total Corporate Tax Payable | $393,540 |

***Non-Eligible RDTOH Balance***

There is no transitional balance in the RDTOH account. The only addition for 2019 would be the refundable portion of Part I tax. This amount would be the least of:

- 30-2/3 Percent Of Investment Income [(30-2/3%)($639,000)] $195,960
- 30-2/3 Percent Of Taxable Income, Less The Amount Eligible For The Small Business Deduction [(30-2/3%)($1,114,000 - $475,000)] $195,960
- Part I Tax Payable $289,830

The least of these items is the $195,960. This amount would be added to the Non-Eligible RDTOH and this would be the ending balance in that account.

***Funds Available For Distribution***
Based on the preceding figures, the amount of cash available for distribution would be calculated as follows:

| | |
|---|---|
| Gross Proceeds For Assets | $2,945,000 |
| Payment Of Liabilities | ( 355,000) |
| Tax Payable | ( 393,540) |
| Dividend Refund (Note) | 195,960 |
| Total Funds Available For Distribution | $2,392,420 |

**Note** Technically, the dividend refund is the lesser of the $195,960 balance in the Non-Eligible RDTOH account and 38-1/3 percent of taxable dividends paid. However, given the size of the distribution in this problem, it is clear that $195,960 will be the lower figure.

***Capital Dividend Account***
The balance in the capital dividend account would be calculated as follows:

| | |
|---|---|
| Opening Balance | Nil |
| Non-Taxable One-Half Of Capital Gains (From Table Calculating Corporate Income On Asset Dispositions) | $639,000 |
| Capital Dividend Account Balance | $639,000 |

***Taxable Dividends Resulting From Distribution***
Assuming an election has been made to declare the maximum capital dividend, the taxable dividend component of the total distribution to Mr. Lange can be calculated as follows:

| | |
|---|---|
| Funds Available For Distribution | $2,392,420 |
| Paid Up Capital | ( 135,000) |
| ITA 84(2) Deemed Dividend | $2,257,420 |
| ITA 83(2) Capital Dividend (Balance In Account) | ( 639,000) |
| Non-Eligible Dividend | $1,618,420 |

There would be no capital gain on the disposition, as demonstrated in the following calculation:

| | |
|---|---|
| Amount Distributed | $2,392,420 |
| ITA 84(2) Deemed Dividend | ( 2,257,420) |
| Deemed Proceeds Of Disposition | $ 135,000 |
| Adjusted Cost Base | ( 135,000) |
| Capital Gain | Nil |

***Personal Tax Payable***

As there is no capital gain and the capital dividend is received tax free, the personal Tax Payable on the dividend subject to tax would be calculated as follows:

| | |
|---|---|
| Non-Eligible Dividend | $1,618,420 |
| 15 Percent Gross Up | 242,763 |
| Taxable Amount Of Dividends | $1,861,183 |
| Combined Rate (33% + 18%) | 51% |
| Tax Before Dividend Tax Credit | $ 949,203 |
| Dividend Tax Credit [(9/13 + 4/13)($242,763)] | ( 242,763) |
| Personal Tax Payable | $ 706,440 |

## Sale Of Shares

The tax payable resulting from a sale of shares would be calculated as follows:

| | |
|---|---|
| Proceeds From The Sale Of Shares | $2,380,000 |
| Adjusted Cost Base | ( 135,000) |
| Capital Gain | $2,245,000 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain | $1,122,500 |
| Tax Rate (33% + 18%) | 51% |
| Personal Tax Payable | $ 572,475 |

**Note** This capital gain would not qualify for the lifetime capital gains deduction because shares of Alcove are not qualified small business corporation shares. The Term Deposits are not involved in producing active business income. As they clearly exceed 10 percent of the fair market value of the assets, Alcove shares are not qualified small business corporation shares.

## Conclusion

Given the preceding calculations, the after tax, personal cash retention under both alternatives would be as follows:

| | Asset Sale | Share Sale |
|---|---|---|
| Proceeds From Sale | $2,392,420 | $2,380,000 |
| Personal Tax Payable | ( 706,440) | ( 572,475) |
| After Tax Retention | $1,685,980 | $1,807,525 |

As the after tax retention is $121,545 ($1,807,525 - $1,685,980) larger when shares are sold, this would be the preferable alternative. If the lifetime capital gains deduction was available, this alternative would have been even more favourable. We would note that this would not have been difficult to accomplish. All that would have been required was the sale of the term deposits and distribution of the proceeds prior to selling the shares.

# Chapter 17 Learning Objectives

After completing Chapter 17, you should be able to:

1. Identify situations where the ITA 85.1 rollover provision is applicable (paragraph [P hereafter] 17-1 to 17-13).
2. Identify situations where the ITA 86 rollover provision is applicable (P 17-14).
3. Apply the ITA 86 rollover procedures to freeze an estate (P 17-15 to 17-16).
4. List the conditions that must be met in order to use the ITA 86 rollover provision (P 17-17 to 17-18).
5. Explain the procedures that are required in implementing an ITA 86 rollover (P 17-19 to 17-29).

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6. Identify situations where the ITA 86(2) benefit rule is applicable and apply the required procedures to specific examples (P 17-30 to 17-40).
7. Describe the major tax planning considerations related to the use of ITA 86 (P 17-41 to 17-46).
8. Explain the nature of an ITA 87 amalgamation (P 17-47 to 17-50).
9. Describe the position of the amalgamated company subsequent to an ITA 87 amalgamation (P 17-51 to 17-55).
10. Describe the position of the shareholders of the amalgamated company subsequent to an ITA 87 amalgamation (P 17-56).

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11. Identify the specific considerations involved in vertical amalgamations (P 17-57).
12. Explain the "asset bump-up" that is available under both ITA 87 and ITA 88(1) (P 17-58 to 17-61).
13. Explain both the non-tax considerations and tax planning considerations related to ITA 87 amalgamations (P 17-62 to 17-65).
14. Explain the nature of an ITA 88(1) winding-up of a 90 percent owned subsidiary (P 17-66 to 17-73).
15. Apply the procedures for recording the assets acquired by the parent company in an ITA 88(1) winding-up of a 90 percent owned subsidiary (P 17-74 to 17-84).

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16. Apply the procedures required for the disposition of shares that occurs in the winding-up of a 90 percent owned subsidiary (P 17-85 and 17-86).
17. Compare the results of applying ITA 87 vs. the results of applying ITA 88(1) and any associated tax planning issues (P 17-87 to 17-93).
18. Apply the procedures required in an ITA 88(2) winding-up of a Canadian corporation (P 17-94 to 17-109).
19. Explain the procedures used under ITA 51 when there is a conversion of a corporation's preferred shares or debt securities (P 17-110 to 17-116).
20. Explain the basic alternatives for the sale of an incorporated business (P 17-117 to 17-118).

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21. Explain the provisions relating to restrictive covenants (a.k.a. non-competition agreements) (P 17-119 to 17-122).
22. Describe the procedures used when the individual assets of a business are sold (P 17-123 to 17-125).
23. Describe the procedures used when the assets of a business are sold as a going concern (P 17-126 to 17-135).
24. Describe the procedures used when the shares of a business are sold (P 17-136 to 17-140).
25. Compare an offer to purchase the shares of a business and an offer to purchase its assets and determine the preferable alternative (P 17-141 to 17-155).

# CHAPTER 18

## How To Work Through Chapter 18

We recommend the following approach in dealing with the material in this chapter:

**Introduction To Partnerships**

- Read paragraph 18-1 to 18-7 (in the textbook).

**Partnerships Defined**

- Read paragraph 18-8 to 18-23.
- Do Self Study Problem Eighteen-1 which is available on MyLab and check the solution in this Study Guide.

**Co-Ownership, Joint Ventures, And Syndicates**

- Read paragraph 18-24 to 18-36.
- Do Self Study Problem Eighteen-2 and check the solution in this Study Guide.

**Determining Partnership Income, Losses, And Tax Credits**

- Read paragraph 18-37 to 18-52.
- Do Exercise Eighteen-1(in the textbook) and check the solution in this Study Guide.
- Read paragraph 18-53 to 18-56.
- Do Exercise Eighteen-2 and check the solution in this Study Guide.
- Read paragraph 18-57 to 18-58.
- Do Exercise Eighteen-3 and check the solution in this Study Guide.

**Allocations To Partners And Partner Expenses**

- Read paragraph 18-59.
- Do Exercise Eighteen-4 and check the solution in this Study Guide.
- Read paragraph 18-60 to 18-62.
- Do Self Study Problems Eighteen-3 and Eighteen-4 and check the solutions in this Study Guide.

**The Partnership Interest**

- Read paragraph 18-63 to 18-74.
- Do Exercise Eighteen-5 and check the solution in this Study Guide.

**Adjustments To The ACB Of A Partnership Interest**

- Read paragraph 18-75 to 18-88.
- Do Exercise Eighteen-6 and check the solution in this Study Guide.
- Read paragraph 18-89 to 18-90.
- Do Self Study Problems Eighteen-5 and Eighteen-6 and check the solutions in this Study Guide.

**Limited Partnerships And Limited Partners**
- Read paragraph 18-91 to 18-102.
- Do Exercise Eighteen-7 and check the solution in this Study Guide.
- Do Self Study Problem Eighteen-7 and check the solution in this Study Guide.

**Transfers Of Property To And From A Partnership - No Rollover**
- Read paragraph 18-103 to 18-108.
- Do Exercise Eighteen-8 and check the solution in this Study Guide.
- Read paragraph 18-109.
- Do Exercise Eighteen-9 and check the solution in this Study Guide.

**Common Partnership Rollovers**
- Read paragraph 18-110 to 18-112.
- Do Exercise Eighteen-10 and check the solution in this Study Guide.
- Read paragraph 18-113 to 18-127.
- Do Self Study Problem Eighteen-8 and check the solution in this Study Guide.

**To Complete This Chapter**
- If you would like more practice in problem solving, do the Supplementary Self Study Problems for the chapter. These problems and solutions are available on MyLab.
- Review the Key Terms Used In This Chapter in the textbook at the end of Chapter 18. Consult the Glossary for the meaning of any key terms you do not know.
- Test yourself with the Chapter 18 Glossary Flashcards available on MyLab.
- Ensure you have achieved the Chapter 18 Learning Objectives listed in this Study Guide.
- As a review, we recommend you view the PowerPoint presentation for Chapter 18 that is on MyLab.

**Practice Examination**
- Write the Practice Examination for Chapter 18 that is on MyLab. Mark your examination using the Practice Examination Solution that is on MyLab.

## Solutions to Chapter Eighteen Exercises

### *Exercise Eighteen - 1 Solution*
The following amounts would be added to Mr. Peter's Net Income For Tax Purposes:

| | |
|---|---|
| Business Income [(50%)($55,000)] | $27,500 |
| Taxable Capital Gains [(50%)(1/2)($40,000)] | 10,000 |
| Eligible Dividends [(50%)($10,000)] | 5,000 |
| Gross Up [(38%)($5,000)] | 1,900 |
| Total Addition | $44,400 |

In addition, Mr. Peters would be eligible for a federal dividend tax credit of $1,036 [(6/11)($1,900)]. The drawings that he made during the year are not included in his 2019 Net Income For Tax Purposes.

### *Exercise Eighteen - 2 Solution*

The JL Partnership's Net Business Income would be calculated as follows:

| | | |
|---|---|---|
| Accounting Net Income | | $262,000 |
| Add: | | |
| Salary To J | $45,000 | |
| Interest To L | 22,000 | |
| Amortization Expense | 26,000 | |
| Donations | 2,500 | 95,500 |
| Subtotal | | $357,500 |
| Deduct: | | |
| Maximum CCA | ($42,000) | |
| Accounting Gain On Sale Of Land | ( 24,000) | ( 66,000) |
| Net Business Income | | $291,500 |
| Priority Allocations For Salary And Interest | | ( 67,000) |
| Residual To Be Split 60:40 | | $224,500 |

The allocation of this Net Business Income to the two partners would be as follows:

| | Partner J | Partner L |
|---|---|---|
| Priority Allocation For Salary | $ 45,000 | N/A |
| Priority Allocation For Interest | N/A | $22,000 |
| Allocation Of Residual | | |
| [(60%)($224,500)] | 134,700 | |
| [(40%)($224,500)] | | 89,800 |
| Total Business Income Allocation | $179,700 | $111,800 |

While not required, you might note that a taxable capital gain of $12,000 [(1/2)($24,000)] would be allocated to the partners on a 60:40 basis. With respect to the donations, the amount of the charitable donations of $2,500 would allocated on a 60:40 basis, leaving the individual partners to calculate the available credit.

### *Exercise Eighteen - 3 Solution*

The ST Partnership's Net Business Income would be calculated as follows:

| | |
|---|---|
| Accounting Net Income | $146,000 |
| Amortization Expense = CCA | Nil |
| Eligible Dividends | ( 12,000) |
| Accounting Gain On Sale Of Land | ( 31,000) |
| Net Business Income | $103,000 |

The addition to Net Income For Tax Purposes for each of the two partners would be calculated as follows:

| | Partner S | Partner T |
|---|---|---|
| Net Business Income [(50%)($103,000)] | $51,500 | $51,500 |
| Eligible Dividends [(50%)($12,000)] | 6,000 | 6,000 |
| Gross Up [(38%)($6,000)] | 2,280 | 2,280 |
| Taxable Capital Gain [(50%)(1/2)($31,000)] | 7,750 | 7,750 |
| Net Income For Tax Purposes Addition | $67,530 | $67,530 |

While not required, you might note that each partner would be eligible for a federal dividend tax credit of $1,244 [(6/11)($2,280)].

### Exercise Eighteen - 4 Solution

The tax credits that would be allocated to each of the partners would be calculated as follows:

| | |
|---|---|
| **Charitable Donations** ($1,750 Each) | |
| [(15%)($200) + (29%)($1,750 - $200)] | $ 480 |
| **Political Contributions** ($600 Each) | |
| [(3/4)($400)] + [(1/2)($200)] | 400 |
| **Eligible Dividends** ($2,100 Each) | |
| [(6/11)(38%)($2,100)] | 435 |
| Total Of Credits To Each Partner | $1,315 |

These amounts would serve to reduce the Tax Payable of each of the two partners for the year ending December 31, 2019.

### Exercise Eighteen - 5 Solution

After the admission of Caitlan, Alan and Balan will each have a one-third interest in the partnership, down from the previous interest of one-half. They are each, in effect, selling one-third of their partnership interest [(1/2 - 1/3) ÷ 1/2)]. The ACB of their distribution to Caitlan is $16,000 [(1/3)($48,000)], resulting in a capital gain of $24,000 ($40,000 - $16,000). The taxable capital gain is one-half of this amount or $12,000.

The partner capital account transactions and ending balances will be:

| | Alan | Balan | Caitlin |
|---|---|---|---|
| Opening Capital Accounts | $48,000 | $48,000 | Nil |
| Adjustment For Caitlin's Admission | ( 16,000) | ( 16,000) | $32,000 |
| Ending Capital Accounts (Accounting Values) | $32,000 | $32,000 | $32,000 |
| ACB Of Partnership Interest | $32,000 | $32,000 | $80,000 |

### Exercise Eighteen - 6 Solution

The ACB of Robert's partnership interest on December 31, 2019 and January 1, 2020 would be determined as follows:

| | |
|---|---|
| Original Capital Contribution | $12,500 |
| Additional Contribution | 7,200 |
| Drawing | ( 4,000) |
| ACB - December 31, 2019 | $15,700 |
| Adjustment For 2019 Income | |
| [(40%)($11,600 + $3,100 + $46,700)] | 24,560 |
| ACB - January 1, 2020 | $40,260 |

Robert's inclusion in Net Income For Tax Purposes would be as follows:

| | |
|---|---|
| Taxable Capital Gain [(40%)(1/2)($11,600)] | $ 2,320 |
| Dividends Received [(40%)($3,100)] | 1,240 |
| Gross Up On Dividends [(40%)(38%)($3,100)] | 471 |
| Net Business Income [(40%)($46,700)] | 18,680 |
| Inclusion In 2019 Net Income For Tax Purposes | $22,711 |

Note that this $22,711 addition to Robert's Net Income For Tax Purposes is not the same amount as the $24,560 that was added to the ACB of Robert's partnership interest to reflect his share of 2019 partnership income. While not required by the problem, Robert can claim a federal dividend tax credit of $257 [(6/11)($471)].

### Exercise Eighteen - 7 Solution

| | | |
|---|---|---|
| ACB Of Partnership Interest | | $200,000 |
| Share Of Partnership Income (Not Loss) For 2019 | | Nil |
| Subtotal | | $200,000 |
| Amounts Owed To The Partnership | ($150,000) | |
| Other Amounts Intended To Reduce Investment Risk (General Partner Guarantee) | ( 50,000) | ( 200,000) |
| At-Risk Amount - December 31, 2019 | | Nil |

As the at-risk amount is nil, none of the loss can be deducted in 2019. The limited partnership loss at the end of 2019 is 100 percent of the $75,000 loss allocation.

### Exercise Eighteen - 8 Solution

**Part A** Charles is considered to have disposed of the land for $100,000, resulting in a $33,500 [(1/2)($100,000 - $33,000)] taxable capital gain. LIU will be considered to have acquired the land for $100,000. Charles is considered to have made a capital contribution of $100,000 that will be added to the ACB of his partnership interest.

**Part B** Charles will have the same $33,500 taxable capital gain as in Part A and LIU will be considered to have acquired the land for $100,000. The capital contribution and the addition to the ACB of the partnership interest is equal to $75,000. This is the difference between the fair market value of the land transferred to LIU of $100,000 and the $25,000 in other consideration received by Charles on the property transfer.

**Part C** Charles will have the same $33,500 taxable capital gain as in Part A and LIU will be considered to have acquired the land for $100,000. No capital contribution is made. As Charles withdrew $12,000 ($112,000 - $100,000) more from LIU than he transferred in, Charles will be considered to have made a net withdrawal. The ACB of his partnership interest will be reduced by $12,000.

### Exercise Eighteen - 9 Solution

ITA 98(2) deems DG to have disposed of the share investments for the fair market value of $94,000, resulting in a $55,000 ($94,000 - $39,000) capital gain. One-fifth of the capital gain, or $11,000, will be allocated to Darlene. One-half of this amount, or $5,500, will be a taxable capital gain that she will include in her income for 2019.

Darlene's adjusted cost base for the share investments is $18,800 [(20%)($94,000)].

The adjusted cost base of her partnership interest on December 31, 2019 and on January 1, 2020 is calculated as follows:

| | |
|---|---|
| Partnership ACB Prior To Distribution | $30,000 |
| Drawings [(20%)($94,000)] | ( 18,800) |
| Partnership ACB - December 31, 2019 | $11,200 |
| Allocated Capital Gain [(20%)($94,000 - $39,000)] | 11,000 |
| Partnership ACB - January 1, 2020 | $22,200 |

### *Exercise Eighteen - 10 Solution*

Using the ITA 85(1) rollover provision, the property would be transferred at the $156,000 ACB of the land. Given this, the transfer would not result in any current income for Samantha. The cost of the land to the partnership would be the $156,000 elected value for the transfer. This same amount would be added to the adjusted cost base of Samantha's partnership interest.

## Self Study Solution Eighteen - 1

The determination of the existence of a partnership is a mixed question of fact and law, based upon the intention of the parties that may be expressed clearly through a valid written partnership agreement or inferred from actions. In Canada, the relevant provincial partnership legislation is applicable to answering this question.

In this case, an analysis of the three elements of a partnership is as follows:

1. **Was the business carried on in common by two or more persons?**

   The details of the partnership agreement contain many of the necessary ingredients that the courts will look to in support of this element. Accordingly, it appears that this element has been met.

2. **Was a business carried on by the partnership?**

   A business has a beginning and an end. Ongoing profitable activity within the business may actually only occur between these two extremes, but the activity remains a business throughout the period. In other words, profitability is generally irrelevant to a finding that a business exists. In this case, the selling off of store property will likely occur as part of the wind up process of the two stores. Accordingly, there are arguments that support the carrying on of a business.

3. **Was there a view to profit?**

   This element will be satisfied if there is a potential for profit even though one may never be realized. The facts clearly lead to a conclusion that there is no hope of profit. The additional fact that the partnership will be terminated once the property is sold and that losses are not only expected, but anticipated, speaks for itself. A tax motivation that predominates, such as this, will not invalidate a partnership as long as there is a profit potential and the other elements are met. This is not the case.

**Conclusion:** A partnership will not be created. As a result, no losses can be allocated to the investors. The losses belong to Wayout Ltd. only.

## Self Study Solution Eighteen - 2

### *Part A - Partnership Results*

As the original intention when the land was purchased was to develop and sell lots, the income from the sale of the lots would be reported as business income and not as a capital gain.

Using the provisions of ITA 97(2), Mr. Marrazzo could transfer the land to the partnership at its ACB of $400,000. There would be no effect on his Net Income For Tax Purposes in 2019. His partnership income inclusion for the two years would be calculated as follows:

| | |
|---|---|
| 2019 Addition To Net Income For Tax Purposes | Nil |

The total net business income resulting from the 2020 sale of the property would be as follows:

| | |
|---|---|
| Proceeds From Lot Sales | $4,400,000 |
| Cost Of Land | ( 400,000) |
| Site Servicing Costs | ( 1,200,000) |
| Net Business Income | $2,800,000 |

Mr. Marrazzo's 2020 addition to his Net Income For Tax Purposes would be calculated as follows:

| | |
|---|---|
| Priority Claim Of Accrued Gain ($1,300,000 - $400,000) | $ 900,000 |
| Allocation Of Remaining Business Income [(50%)($2,800,000 - $900,000)] | 950,000 |
| 2020 Addition To Net Income For Tax Purposes | $1,850,000 |

***Part A - Joint Venture Results***

No rollover under ITA 85(1) could take place because land inventory is not an eligible property. As a result, Mr. Marrazzo would recognize a 2019 gain on the transfer to Digger Inc. of $900,000 ($1,300,000 - $400,000). As previously noted, this gain would be treated as business income. His partnership income inclusion for the two years would be calculated as follows:

| | |
|---|---|
| 2019 Addition To Net Income For Tax Purposes | $ 900,000 |
| Proceeds Of Disposition - Digger's Sale Of The Land | $4,400,000 |
| Adjusted Cost Base Of Land | ( 1,300,000) |
| Site Servicing Costs | ( 1,200,000) |
| Net Business Income | $1,900,000 |
| Mr. Marrazzo's Share | 50% |
| 2020 Addition To Net Income For Tax Purposes | $ 950,000 |

The addition to his Net Income For Tax Purposes over the two years is $1,850,000 ($900,000 + $950,000), the same total as in Part A.

***Part A - Comparison***

In total, Mr. Marrazzo will report the same increase in Net Income For Tax Purposes regardless of which form of organization is used. However, with the joint venture, he would have to report $900,000 of the income in 2019 and $950,000 in 2020. With the partnership, the entire $1,850,000 in income would be reported in 2020. Given that this approach provides significant tax deferral, the partnership approach appears preferable.

***Part B - Adjusted Cost Base***

The ACB of Mr. Marrazzo's partnership interest would be calculated as follows:

| | |
|---|---|
| Capital Contribution - 2019 | $ 400,000 |
| Income Allocated To Mr. Marrazzo For 2019 | Nil |
| ACB - December 31, 2020 | $ 400,000 |
| Income Allocated To Mr. Marrazzo For 2020 (Part A) | 1,850,000 |
| Mr. Marrazzo's ACB - January 1, 2021 | $2,250,000 |

At this point, a winding up of the partnership would have no tax consequences for Mr. Marrazzo.

The ACB of Digger Inc.'s partnership interest would be calculated as follows:

| | |
|---|---|
| Capital Contribution - 2019 | Nil |
| Income Allocated To Digger For 2019 | Nil |
| Capital Contribution - 2020 = Servicing Costs | $1,200,000 |
| ACB - December 31, 2020 | $1,200,000 |
| Income Allocated To Digger For 2020 | |
| [(50%)($2,800,000 - $900,000) - See Part A] | 950,000 |
| Digger Inc.'s ACB - January 1, 2021 | $2,150,000 |

## Self Study Solution Eighteen - 3

### *Partnership Net Business Income*

The Net Business Income of the partnership is calculated as follows:

| | | |
|---|---|---|
| Net Income As Per Income Statement | | $192,100 |
| Additions: | | |
| Partners' Salaries [(2)($44,000)] | $88,000 | |
| Amortization Deducted | 12,500 | |
| Charitable Donations | 7,200 | |
| Closing Accounts Receivable (Note One) | 56,000 | 163,700 |
| Deductions: | | |
| Opening Accounts Receivable (Note One) | ($27,000) | |
| Capital Gains On Securities (Note Two) | ( 14,000) | |
| Dividends Received (Note Three) | ( 48,000) | |
| CCA: | | |
| Class 8 [(20%)($26,000)] | ( 5,200) | |
| Class 50 [(55%)(150%)($8,500)] | ( 7,013) | ( 101,213) |
| Net Business Income | | $254,587 |

**Note One** The addition of closing accounts receivable and the deduction of the opening accounts receivable are required to adjust the cash based income figure to an accrual based income figure.

**Note Two** The total capital gain is deducted in the calculation of net business income. The taxable one-half of these gains is included on a flow through basis in the income of the individual partners.

**Note Three** The dividends received are deducted in the calculation of net business income. They are flowed through as eligible dividends in the income of the individual partners.

***Mr. Caldwell's Personal Income***

Mr. Caldwell's Net Income For Tax Purposes would be calculated as follows:

| | | |
|---|---|---|
| Partnership Net Business Income | $254,587 | |
| Mr. Caldwell's Share | 50% | $127,294 |
| Automobile Costs: | | |
| CCA [($13,500)(30%)(75%)] | | ( 3,038) |
| Operating Costs [($4,000)(75%)] | | ( 3,000) |
| Net Business Income From Professional Practice | | $121,256 |
| Other Partnership Income: | | |
| Taxable Capital Gains [(1/2)($14,000)] | $ 7,000 | |
| Eligible Dividends Received | 48,000 | |
| Gross Up On Dividends [(38%)($48,000)] | 18,240 | |
| Subtotal | $73,240 | |
| Mr. Caldwell's Share | 50% | 36,620 |
| Net Income For Tax Purposes | | $157,876 |

Mr. Caldwell's $3,600 [(50%)($7,200)] share of the charitable donations can be used as the basis for a credit against his personal Tax Payable. The amount of the credit would be $1,016 [(15%)($200) + (29%)($3,600 - $200)] assuming this is his only charitable donation.

He is also entitled to a federal dividend tax credit of $4,975 [(50%)(6/11)($18,240)].

## Self Study Solution Eighteen - 4

***Part A - Income Inclusions***

CCC has three sources of income. These are business income, property income (dividends), and taxable capital gains.

The calculation of the partnership's Net Business Income is as follows:

| | | |
|---|---|---|
| Net Income From Coffee Roasting | | $37,200 |
| Add: | | |
| Salaries To Partners [(3)($2,400)] | $7,200 | |
| Interest On Capital Contributions | 2,000 | |
| Personal Partner Expenses | 1,100 | |
| Charitable Donations | 1,000 | |
| Accounting Amortization | 1,450 | 12,750 |
| Deduct: | | |
| CCA | | ( 2,000) |
| Net Business Income | | $47,950 |
| Priority Allocations For Salaries And Interest ($7,200 + $2,000) | | ( 9,200) |
| Residual To Be Allocated | | $38,750 |

This amount would be allocated to the three partners as follows:

| | Christine | Jennifer And Danny (Each) |
|---|---|---|
| Priority Allocation For Salaries | $2,400 | $2,400 |
| Priority Allocation For Interest | 2,000 | N/A |
| Allocation Of Residual On Equal Basis [(1/3)($38,750)] | 12,917 | 12,917 |
| Total Business Income Allocation | $17,317 | $15,317 |

Other non-business income inclusions for each partner related to partnership activities would be as follows:

| | |
|---|---|
| Eligible Dividends Received | $3,440 |
| Gross Up [(38%)($3,440)] | 1,307 |
| Taxable Capital Gains [(1/2)($6,000)] | 3,000 |
| Total To Be Allocated | $7,747 |
| Each Partner's Share | 1/3 |
| Non-Business Income Allocation | $2,582 |

This results in an addition to Net Income For Tax Purposes for Jennifer and Danny of $17,899 ($15,317 + $2,582). For Christine, the increase would include the $2,000 in interest and would equal $19,899 ($17,317 + $2,582).

***Part B - Tax Credits***

**Charitable Donations** Each partner would be allocated $333 ($1,000 ÷ 3) in charitable donations. This would provide a federal tax credit of $69 [(15%)($200) + (29%)($133)] assuming this is their only charitable donation.

**Dividends** Each of the partners would be eligible for a federal dividend tax credit of $238 [(1/3)(6/11)(38%)($3,440)].

## Self Study Solution Eighteen - 5

***Barry's Federal Tax Payable***

The Net Business Income of the partnership would be calculated as follows:

| | | |
|---|---|---|
| Operating Income | | $458,668 |
| Additions: | | |
| Amortization Expense | $17,466 | |
| One-Half Meals And Entertainment [(1/2)($9,740)] | 4,870 | |
| Charitable Donations | 8,658 | |
| Opening Work In Progress [(80%)($65,464)] - See Note | 52,371 | 83,365 |
| Deductions: | | |
| CCA | ($23,562) | |
| Ending Work In Progress [(60%)($90,210)] - See Note | ( 54,126) | ( 77,688) |
| Net Business Income | | $464,345 |

**Note** As discussed in Chapter 6, the billed basis of revenue recognition is being phased out over a five year period beginning in 2018. Beginning in that year, the amount of unbilled work in process that can be deferred is reduced by 20 percent each year. This means that, in 2018, 80 percent of the unbilled work in process was deferred. This must be added back in this year. For 2019, 60 percent of unbilled work in process can be deferred.

Barry's Taxable Income and share of charitable donations for the year ending December 31, 2019 would be calculated as follows:

| | Partnership | Share | Taxable Income |
|---|---|---|---|
| Partnership Business Income | $464,345 | 60% | $278,607 |
| Taxable Capital Gain [(1/2)($18,660)] | 9,330 | Nil | Nil |
| Partnership Dividends Received | 12,390 | 50% | 6,195 |
| 38% Gross Up On Dividends Received | N/A | | 2,354 |
| Taxable Income | | | $287,156 |

| | | | |
|---|---|---|---|
| Charitable Donations | $8,658 | 50% | $4,329 |

Based on the preceding calculation, Barry's 2019 federal Tax Payable would be calculated as follows:

| | |
|---|---|
| Tax On The First $210,371 | $48,719 |
| Tax On Additional | |
| $76,785 ($287,156 - $210,371) At 33 Percent | 25,339 |
| Tax Payable Before Credits | $74,058 |
| Basic Personal Credit [(15%)($12,069)] | ( 1,810) |
| Dividend Tax Credit [(6/11)($2,354)] | ( 1,284) |
| Charitable Donations Credit (See Note) | ( 1,393) |
| Federal Tax Payable | $69,571 |

**Note** The charitable donations tax credit would be calculated as follows:

[(15%)(A)] + [(33%)(B)] + [(29%)(C)], where

A = $200
B = The Lesser Of:
- $4,329 - $200 = $4,129
- $28,7156 - $210,371 = $76,785

C = Nil [$4,329 - ($200 + $4,129)]

The charitable donation credit would be equal to $1,393, calculated as [(15%)($200) + (33%)($4,129)].

### *Taxable Capital Gain From Sale Of Partnership Interest*

The adjusted cost base of Barry's partnership interest on January 1, 2020 would be calculated as follows:

| | Partnership | Share | ACB |
|---|---|---|---|
| Capital Contribution | N/A | | $275,000 |
| 2018 Partnership Business Income | $372,466 | 60% | 223,480 |
| 2018 Drawings | N/A | | ( 114,000) |
| 2019 Drawings | N/A | | ( 142,000) |
| December 31, 2019 | | | $242,480 |
| 2019 Partnership Business Income | $459,396 | 60% | 278,607 |
| 2019 Capital Gain | 9,330 | Nil | Nil |
| 2019 Partnership Dividends Received | 12,390 | 50% | 6,195 |
| 2019 Charitable Donations | ( 8,658) | 50% | ( 4,329) |
| January 1, 2020 Adjusted Cost Base | | | $522,953 |

Given this calculation, the taxable capital gain on Barry's sale of the partnership interest would be calculated as follows:

| | |
|---|---|
| Proceeds Of Disposition | $656,000 |
| Adjusted Cost Base | ( 522,953) |
| Capital Gain | $133,047 |
| Inclusion Rate | 1/2 |
| Taxable Capital Gain | $ 66,524 |

## Self Study Solution Eighteen - 6

### *Part A - Adjusted Cost Base*

The adjusted cost base of John Mathis' partnership interest would be calculated as follows:

| | |
|---|---|
| Initial Capital Contribution | $200,000 |
| Additional Capital Contribution | 75,000 |
| Total Capital Contribution | $275,000 |
| Drawings | ( 55,000) |
| Net Business Income [(1/3)($233,460)] | 77,820 |
| Capital Gains To Monroe and Mathis [(50%)($18,464)] | 9,232 |
| Dividends To Darin | Nil |
| Charitable Donations [(1/3)($8,460)] | ( 2,820) |
| Adjusted Cost Base - January 1, 2020 | $304,232 |

**Note** Only the taxable one-half of the capital gain is included in the partner's income on the flow through of capital gains realized by a partnership. However, the remaining one-half is included in the assets of the partnership and, in the absence of a special provision to deal with this situation, the realization of this amount would be added to any capital gain realized on the disposition of the partnership interest. Given this, the full amount of John's share of realized capital gains is added to the partnership adjusted cost base.

### *Part B - Taxable Capital Gain On Disposition*

Given the preceding calculation, the gain on the disposition of the partnership interest can be calculated as follows:

| | | |
|---|---|---|
| Proceeds Of Disposition | | $320,000 |
| Adjusted Cost Base: | | |
| From Preceding Calculation | ($304,232) | |
| Legal And Accounting Fees | ( 1,800) | ( 306,032) |
| Capital Gain | | $ 13,968 |
| Inclusion Rate | | 1/2 |
| Taxable Capital Gain | | $ 6,984 |

This amount would be included in John Mathis's Net Income For Tax Purposes for 2020 as a taxable capital gain. He would not include any partnership income for January as he was not allocated any of this income.

### *Part C - Effect On Other Partners*

The fact that each partner paid $160,000 to John in return for one-half of his interest means that both Bob Darin and Matt Monroe would have a $160,000 increase in the adjusted cost base of their partnership interest.

## Self Study Solution Eighteen - 7

### *Timing Of Income Inclusions For At-Risk Amounts vs. ACB*

The addition of the share of the partnership income amounts to the at-risk balance as at December 31 is intended to ensure that this amount is taken into consideration in determining the amount that is actually at risk on that date. Notice, however, losses are not deducted at this time in the determination of the at-risk amount.

We would remind you that in calculating the adjusted cost base of the partnership interest, a partner's share of either a loss or a gain is not added until the first day of the following taxation year.

**2019 Results**

The required amounts would be calculated as follows:

| | |
|---|---|
| ACB Of Partnership Interest - December 31, 2019 | $50,000 |
| Add: Share Of 2019 Partnership Income (Not Loss) | Nil |
| Subtotal | $50,000 |
| Amounts Owed To The Partnership | ( 20,000) |
| At-Risk Amount - December 31, 2019 | $30,000 |

| | |
|---|---|
| Share of 2019 Loss [(10%)($400,000)] | ($40,000) |
| At-Risk Amount - December 31, 2019 | 30,000 |
| Limited Partnership Loss - December 31, 2019 | ($10,000) |

| | |
|---|---|
| Share of 2019 Loss [(10%)($400,000)] | ($40,000) |
| Limited Partnership Loss - December 31, 2019 | 10,000 |
| Deductible Loss For 2019 | ($30,000) |

There is a limited partnership loss carry forward of $10,000 at the end of 2019.

**2020 Results**

| | |
|---|---|
| ACB Of Partnership Interest - December 31, 2019 | $50,000 |
| Loss Deducted For 2019 | ( 30,000) |
| ACB Of Partnership Interest - December 31, 2020 | $20,000 |
| Add: Share Of 2020 Partnership Income (Not Loss) | Nil |
| Subtotal | $20,000 |
| Amounts Owed To The Partnership | Nil |
| At-Risk Amount - December 31, 2020 | $20,000 |

| | |
|---|---|
| Share of 2020 Loss [(10%)($70,000)] | ($ 7,000) |
| Limited Partnership Loss Carry Forward | ( 10,000) |
| At-Risk Amount - December 31, 2020 | 20,000 |
| Limited Partnership Loss - December 31, 2020 | Nil |

| | |
|---|---|
| Share of 2020 Loss [(10%)($70,000)] | ($ 7,000) |
| Limited Partnership Loss Carry Forward | ( 10,000) |
| Limited Partnership Loss - December 31, 2020 | Nil |
| Deductible Loss For 2020 | ($17,000) |

The $10,000 limited partnership loss carry forward from 2019 can be deducted as it is less than $13,000, the December 31, 2020 at-risk amount of $20,000 reduced by the allocated share of the 2020 partnership loss of $7,000. As a result, there is no limited partnership loss carry forward at the end of 2020.

**2021 Results**

| | |
|---|---|
| ACB Of Partnership Interest - December 31, 2020 | $20,000 |
| Loss Deducted For 2020 | ( 17,000) |
| ACB Of Partnership Interest - December 31, 2021 | $ 3,000 |
| Add: Share Of 2021 Partnership Income | Nil |
| Subtotal | $ 3,000 |
| Amounts Owed To The Partnership | Nil |
| At-Risk Amount - December 31, 2021 | $ 3,000 |

There is no limited partnership loss or deductible loss for 2021 and no limited partnership loss carry forward at the end of 2021.

**Summary Of Results**

The results are summarized in the following table:

| | 2019 | 2020 | 2021 |
|---|---|---|---|
| ACB Of The Partnership Interest - December 31 | $50,000 | $20,000 | $ 3,000 |
| At-Risk Amount - December 31 | 30,000 | 20,000 | 3,000 |
| Limited Partnership Loss | 10,000 | Nil | Nil |
| Deductible Loss | 30,000 | 17,000 | Nil |
| Limited Partnership Loss Carry Forward - December 31 | 10,000 | Nil | Nil |

## Self Study Solution Eighteen - 8

***Part A - Adjusted Cost Base Of Consideration***

**Cash** With all non-share consideration, the ACB is equal to its fair market value. In the case of cash, the fair market value is equal to the face value. These amounts would be $78,000 for Porter, $222,000 for Quinn, and $422,000 for Roberts.

**Part A - Adjusted Cost Base Of Preferred Shares** With respect to the preferred shares received by each partner, ITA 85(3)(e) indicates that their ACB will be the lesser of:

- Their fair market value, which would be $180,000 for each of the three partners.
- The ACB of each partnership interest, reduced by the amount of non-share consideration received by the partner.

This latter value would be calculated as follows for each of the three partners:

| | Porter | Quinn | Roberts |
|---|---|---|---|
| ACB (Equals Total Elected Value Of Corporate Assets Received) | $382,000 | $526,000 | $726,000 |
| Cash Received | ( 78,000) | ( 222,000) | ( 422,000) |
| Balance | $304,000 | $304,000 | $304,000 |

For each of the three partners, the lower figure would be the fair market value of $180,000 and, as a consequence, this would be the ACB of their preferred shares.

**Part A - Adjusted Cost Base Of Common Shares** Under ITA 85(3)(f), the ACB of the common shares received by each partner would be the ACB of their partnership interest, less the sum of the value of the non-share consideration received and the value assigned to the preferred shares received. These amounts would be calculated as follows:

| | Porter | Quinn | Roberts |
|---|---|---|---|
| ACB - Partnership Interest | $382,000 | $526,000 | $726,000 |
| Cash Received | ( 78,000) | ( 222,000) | ( 422,000) |
| ACB - Preferred Shares | ( 180,000) | ( 180,000) | ( 180,000) |
| ACB - Common Shares | $124,000 | $124,000 | $124,000 |

***Part B - Capital Gain Or Loss***

As the non-share consideration had a value that was less than the value of the assets transferred, there will be no immediate gain or loss on this rollover. This can be demonstrated with the following calculation:

| | Porter | Quinn | Roberts |
|---|---|---|---|
| Proceeds Of Disposition: | | | |
| Cash | $ 78,000 | $222,000 | $422,000 |
| Preferred Shares | 180,000 | 180,000 | 180,000 |
| Common Shares | 124,000 | 124,000 | 124,000 |
| Total Proceeds | $382,000 | $526,000 | $726,000 |
| ACB | ( 382,000) | ( 526,000) | ( 726,000) |
| Capital Gain (Loss) | Nil | Nil | Nil |

From an economic point of view the gain is still present. The partners have simply deferred recording it for tax purposes by placing a value on the common shares of $372,000 [(3)($124,000)]. This is significantly below their current fair market value of $1,080,000. Note that the difference of $708,000 ($1,080,000 - $372,000) is also the difference between the $2,342,000 fair market value of the total consideration given and the $1,634,000 value for the total ACB of the partnership interests.

## Chapter 18 Learning Objectives

1. Explain the basic approach of Canadian income tax legislation to the taxation of partnerships (paragraph [P hereafter] 18-1 to 18-7).
2. Define, for income tax purposes, a partnership arrangement (P 18-8 to 18-15).
3. List the various types of partnership arrangements that are used in Canada (P 18-16 to 18-23).
4. Describe the difference between partnership arrangements and such other forms of organization as co-ownership, joint ventures, and syndicates (P 18-24 to 18-36).
5. Explain the basic concepts that are involved in the determination of the partnership income, losses, and tax credits to be allocated to the partners (P 18-37 to 18-52).

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6. Calculate the Net Business Income of the partnership (P 18-53 to 18-54).
7. Calculate the amount and type of partnership income other than business income that will be allocated to each partner under the terms of the partnership agreement (P 18-55 to 18-62).
8. Explain the concept of the adjusted cost base of a partnership interest (P 18-63 to 18-66).
9. Apply the procedures required to record the acquisition of a partnership interest (P 18-67 to 18-74).
10. Calculate the amount of the adjusted cost base of a partnership interest (P 18-75 to 18-88).

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11. Apply the procedures required to record the disposition of a partnership interest because of a sale or withdrawal (P 18-89 to 18-90).
12. Define limited partner and limited partnership arrangement (P 18-91 to 18-93).
13. Apply the at-risk rules to limited partnership losses (P 18-94 to 18-102).
14. Define a Canadian partnership (P 18-103 to 18-106).
15. Apply the procedures related to transfers between a partnership and its partners when no rollover provision is used (P 18-107 to 18-109).
16. List and apply the common rollover provisions for transfers between a partnership and its partners (P 18-110 to 18-127).

# CHAPTER 19

## How To Work Through Chapter 19

We recommend the following approach in dealing with the material in this Chapter:

**Introduction To Trusts And Estate Planning**

- Read the Note at the beginning of the Chapter to 19-7 (in the textbook).

**Basic Concepts**

- Read paragraph 19-8 to 19-23.

**Establishing A Trust**

- Read paragraph 19-24 to 19-27.
- Do Exercise Nineteen-1 (in the textbook) and check the solution in this Study Guide.

**Returns And Payments - Trusts**

- Read paragraph 19-28 to 19-29.

**Non-Tax Reasons For Using Trusts**

- Read paragraph 19-30 to 19-31.

**Classification Of Trusts (Personal, Testamentary And Inter Vivos)**

- Read paragraph 19-32 to 19-51.

**Taxation Of Trusts - The Basic Model**

- Read paragraph 19-52 to 19-55.
- Do Exercise Nineteen-2 and check the solution in this Study Guide.

**Rollovers To A Trust**

- Read paragraph 19-56 to 19-64.
- Do Exercise Nineteen-3 and check the solution in this Study Guide.
- Read paragraph 19-65 to 19-68.
- Do Exercise Nineteen-4 and check the solution in this Study Guide.

**Rollovers To Capital Beneficiaries**

- Read paragraph 19-69 to 19-74.
- Do Self Study Problem Nineteen-1 which is available on MyLab and check the solution in this Study Guide.

**21 Year Deemed Disposition Rule And Other Deemed Dispositions**

- Read paragraph 19-75 to 19-78.

**Net Income For Tax Purposes And Taxable Income Of A Trust**

- Read paragraph 19-79 to 19-92.
- Do Exercise Nineteen-5 and check the solution in this Study Guide.

**Income Allocations To Beneficiaries**

- Read paragraph 19-93 to 19-109.
- Do Exercise Nineteen-6 and check the solution in this Study Guide.

**Allocation Of Business Income, CCA, Recapture of CCA, And Terminal Losses**

- Read paragraph 19-110 and 19-111.
- Do Exercise Nineteen-7 and check the solution in this Study Guide.

**Principal Residence Exemption**

- Read paragraph 19-112.

**Tax Payable Of Personal Trusts**

- Read paragraph 19-113 to 19-125.
- Do Exercise Nineteen-8 and check the solution in this Study Guide.
- Do Self Study Problems Nineteen-2 to Nineteen-4 and check the solutions in this Study Guide.

**Income Attribution - Trusts**

- Read paragraph 19-126 to 19-128.
- Do Exercise Nineteen-9 and check the solution in this Study Guide.
- Do Self Study Problems Nineteen-5 and Nineteen-6 and check the solutions in this Study Guide.
- Read paragraph 19-129 to 19-131.

**Purchase Or Sale Of An Interest In A Trust**

- Read paragraph 19-132 to 19-137.
- Do Exercise Nineteen-10 and check the solution in this Study Guide.

**Tax Planning Using Trusts (Family, Spousal And Alter Ego Trusts)**

- Read paragraph 19-138 to 19-146.
- Do Exercise Nineteen-11 and check the solution in this Study Guide.
- Read paragraph 19-147 to 19-151.

**Estate Planning - Tax And Non-Tax Considerations**

- Read paragraph 19-152 to 19-156.

**Estate Freeze - Objectives And Techniques, Including ITA 86 Share Exchange**

- Read paragraph 19-157 to 19-178.

**SIFT Partnerships And Trusts**

- Read paragraph 19-179.

**To Complete This Chapter**

- If you would like more practice in problem solving, do the Supplementary Self Study Problems for the chapter. These problems and solutions are available on MyLab.
- Review the Key Terms Used In This Chapter in the textbook at the end of Chapter 19. Consult the Glossary for the meaning of any key terms you do not know.
- Test yourself with the Chapter 19 Glossary Flashcards available on MyLab.
- Ensure you have achieved the Chapter 19 Learning Objectives listed in this Study Guide.
- As a review, we recommend you view the PowerPoint presentation for Chapter 19 that is on MyLab.

**Practice Examination**

- Write the Practice Examination for Chapter 19 that is on MyLab. Mark your examination using the Practice Exam Solution that is on MyLab.

# Solutions to Chapter Nineteen Exercises

### Exercise Nineteen - 1 Solution

**Case A** While Mr. Black has transferred property, it is not clear that his intention was to create a trust. No trust would be created by his transfer.

**Case B** Jane's "friends" cannot be considered to be an identifiable class. As a consequence, there is no certainty as to beneficiaries and no trust would be created by her transfer.

**Case C** Robert's "children" would be an identifiable class. It would appear that a trust has been created.

**Case D** While Suzanne has signed the agreement, it does not appear that the property has been transferred. This means that no trust has been created.

### Exercise Nineteen - 2 Solution

With respect to Joanne's transfer of her securities to the trust, the transaction would be deemed to take place at fair market value. This would result in a taxable capital gain to Joanne of $10,000 [(1/2)($220,000 - $200,000)]. There would be no tax consequences to Jocelyn or the trust as a result of this transfer.

As the trust distributed all of its income during the year, none of the interest would be taxed in the trust. All of the interest would be included in Jocelyn's income and, because she is an adult, there would be no income attribution to Joanne.

Under ITA 107(2), the transfer from the trust to Jocelyn on January 1, 2020 would take place at the trust's tax cost of $220,000. There would be no tax consequences for Joanne, Jocelyn, or the trust as a result of this transfer. However, as Jocelyn's adjusted cost base is $220,000, the sale at the fair market value of $230,000 would result in a taxable capital gain of $5,000 [(1/2)($230,000 - $220,000)].

### Exercise Nineteen - 3 Solution

As there is a rollover available on transfers to a qualifying spousal trust, the accrued $30,000 gain ($90,000 - $60,000) will not be recognized until her husband or the spousal trust eventually disposes of the stocks. The spousal trust acquires the stocks (a non-depreciable capital asset) at Louise's adjusted cost base of $60,000, which will be her husband's adjusted cost base if the trust transfers the stocks to him personally rather than selling them.

### Exercise Nineteen - 4 Solution

In Scenarios 1, 2 and 3, the settlor has a taxable capital gain of $300 [(1/2)($1,600 - $1,000)] and the adjusted cost base to the trust is the fair market value of $1,600. In Scenarios 4 to 7, there is a tax free rollover. The results can be summarized as follows:

| Scenario | Taxable Capital Gain (Settlor) | Adjusted Cost Base (Trust) |
|---|---:|---:|
| 1. Inter vivos trust for adult child | $300 | $1,600 |
| 2. Inter vivos trust for minor child | 300 | 1,600 |
| 3. Testamentary trust for friend | 300 | 1,600 |
| 4. Inter vivos qualifying spousal trust | Nil | 1,000 |
| 5. Testamentary qualifying spousal trust | Nil | 1,000 |
| 6. Joint spousal trust | Nil | 1,000 |
| 7. Alter ego trust | Nil | 1,000 |

### *Exercise Nineteen - 5 Solution*

The required calculations are as follows:

| | |
|---|---|
| Business Income | $220,000 |
| Preferred Beneficiary Election | ( 50,000) |
| Distributions To Other Beneficiaries | ( 170,000) |
| Designation Under ITA 104(13.1) Amounts Deemed Not Paid | 35,000 |
| Net Income For Tax Purposes | $ 35,000 |
| Business Loss Carry Forward | ( 35,000) |
| Taxable Income | Nil |

The preferred beneficiary election would mean that the $50,000 would be taxed in the hands of the disabled beneficiary even though the funds are retained in the trust. Since this is an inter vivos trust, without the election, the $50,000 would be taxed at the maximum rate in the trust. As the disabled beneficiary has no other source of income, the $50,000 would be subject to tax at lower rates than would be the case if it was taxed in the trust.

By designating $35,000 as amounts not paid, the trust can absorb the loss carry forward. As a result, the beneficiaries will not pay tax on this amount even though it has been distributed to them.

### *Exercise Nineteen - 6 Solution*

The income allocation would be as follows:

| | Received By Trust | Paid To Bryan | Retained By Trust |
|---|---|---|---|
| Eligible Dividends | $100,000 | $ 60,000 | $40,000 |
| Non-Eligible Dividends From CCPC | 30,000 | 30,000 | Nil |
| Capital Gain | 20,000 | 20,000 | Nil |
| Totals | $150,000 | $110,000 | $40,000 |

The Net Income For Tax Purposes of the trust would be calculated as follows:

| | |
|---|---|
| Eligible Dividends | $ 40,000 |
| Gross Up Of Eligible Dividends At 38 Percent | 15,200 |
| Net Income For Tax Purposes - Trust | $ 55,200 |

The corresponding calculation for Bryan would be as follows:

| | |
|---|---|
| Eligible Dividends | $ 60,000 |
| Gross Up Of Eligible Dividends At 38 Percent | 22,800 |
| Non-Eligible Dividends From CCPC | 30,000 |
| Gross Up Of Non-Eligible Dividends At 15 Percent | 4,500 |
| Taxable Capital Gains [(1/2)($20,000)] | 10,000 |
| Net Income For Tax Purposes - Bryan | $127,300 |

Note that the non-taxable one-half of the capital gain would be received by Bryan on a tax free basis. Both the trust and Bryan will be able to deduct a federal dividend tax credit against federal Tax Payable. The TOSI is not applicable as Bryan is over 18 years of age and is actively engaged in the private corporation on a regular and continuous basis.

### Exercise Nineteen - 7 Solution

If the property is sold in December, 2019, no CCA can be deducted. This means that the total amount of property income to be distributed to Martin and taxed in his hands is $97,000 ($32,000 of rental income, plus $65,000 of recapture). Given this distribution, the trust's Net Income For Tax Purposes will be nil.

Alternatively, if the rental property is not sold and all of the income is distributed to Martin, he will include $6,000 ($32,000 - $26,000) in his 2019 Net Income For Tax Purposes. The trust's 2019 Net Income For Tax Purposes will be nil.

### Exercise Nineteen - 8 Solution

The Taxable Income in Parts A, B and C is the same and would be calculated as follows:

| | |
|---|---|
| Eligible Dividends Received | $100,000 |
| Gross Up At 38 Percent | 38,000 |
| Taxable Income | $138,000 |

**Part A** As all of its 2019 income has been distributed, there would be no Taxable Income or Tax Payable for the trust. This conclusion would not be changed if the trust was an inter vivos trust, rather than a testamentary trust. The beneficiary's federal Tax Payable on the Taxable Income of $138,000 is calculated in the following table.

**Part B** As none of the dividends are distributed by the trust to the beneficiary, there would be no Taxable Income or Tax Payable for the beneficiary. The trust's federal Tax Payable on the Taxable Income of $138,000 is calculated in the table which follows.

The federal Tax Payable for Parts A and B would be calculated as follows:

| | Part A | Part B |
|---|---|---|
| Tax On First $95,259 | $16,908 | $16,908 |
| Tax On Next $42,741 ($138,000 - $95,259) At 26 Percent | 11,113 | 11,113 |
| Total Tax Before Credits | $28,021 | $28,021 |
| Personal Tax Credit [(15%)($12,069)] | ( 1,810) | N/A |
| Federal Dividend Tax Credit [(6/11)($38,000)] | ( 20,727) | ( 20,727) |
| Federal Tax Payable | $ 5,484 | $ 7,294 |

Notice that the difference between the Tax Payable in Part A and Part B is $1,810 ($7,294 - $5,484). This amount is equal to the basic personal tax credit.

**Part C** Once again, with no distributions to the beneficiary, the trust's Taxable Income would be $138,000. There would be no Taxable Income or Tax Payable for the beneficiary. Based on this, the Tax Payable for the inter vivos trust would be calculated as follows:

| | |
|---|---|
| Tax On $138,000 At 33 Percent | $45,540 |
| Federal Dividend Tax Credit [(6/11)($38,000)] | ( 20,727) |
| Federal Tax Payable | $24,813 |

**Comparison** As a comparison of these examples makes clear, if a trust has beneficiaries with no other sources of income, overall tax payments will be reduced by distributing eligible dividends to beneficiaries (Part A). While these examples do not illustrate this possibility, the conclusion would be the same if non-eligible dividends were involved. Note that the results in Part C would be the same for a testamentary trust that was not designated a graduated rate estate. In Parts B and C where the trust has paid the tax, the dividends would be distributed to the beneficiary on a tax free basis. However, in Part C, if the beneficiaries have a marginal federal tax rate that is less than 33 percent, there will be a tax cost in having the trust pay the tax.

### *Exercise Nineteen - 9 Solution*

Income on the bonds is subject to the attribution rules to the extent that the income is allocated to Trevor's spouse, Carmen, and to their minor son, Mitch. This means that two-thirds of the interest will be attributed back to Trevor. With respect to the capital gain, the attribution rules do not apply on transfers to minors. This means that only Carmen's share of the gain will be attributed back to Trevor. The increase in Taxable Income for Trevor and the trust's beneficiaries are calculated as follows:

| | Carmen | Mitch | Rhonda | Attributed To Trevor |
|---|---|---|---|---|
| Interest Income ($27,000 ÷ 3) | $9,000 | $9,000 | $ 9,000 | |
| Interest Attribution To Trevor | ( 9,000) | ( 9,000) | Nil | $18,000 |
| Taxable Capital Gain [(1/2)($6,000) ÷ 3] | 1,000 | 1,000 | 1,000 | |
| Capital Gain Attribution To Trevor | ( 1,000) | Nil | Nil | 1,000 |
| Increase In Taxable Income | Nil | $1,000 | $10,000 | $19,000 |

If Trevor had died on January 1 of the current year, there would be no income attribution for the year. Each of the beneficiaries would have Taxable Income of $10,000.

### *Exercise Nineteen - 10 Solution*

With respect to Sam, he has acquired a capital interest for consideration of $190,000. This will be the adjusted cost base of the interest he has acquired.

With respect to Mehrdad, he has disposed of a capital asset for proceeds of disposition of $190,000. Since he did not purchase the interest in the trust, his adjusted cost base as usually determined would be nil. However, for this disposition, the adjusted cost base of the capital interest is the greater of nil and the cost amount as determined under ITA 108(1). The cost amount would be $125,000, one-half of the $250,000 tax cost of the assets in the trust. The result would be a taxable capital gain of $32,500 [(1/2)($190,000 - $125,000)].

The original cost of the securities of $120,000 is not relevant in these calculations as the father was taxed on the $130,000 ($250,000 - $120,000) capital gain in the year the securities were transferred.

### *Exercise Nineteen - 11 Solution*

As Sarah's other income places her in the maximum federal tax bracket of 33 percent, her federal tax savings resulting from transferring the assets to the family trust would be $36,300 [($110,000)(33%)]. The federal tax that would be payable on the additional $55,000 received by Jerri is as follows:

| | |
|---|---|
| Tax On First $47,630 | $7,145 |
| Tax On Additional $7,370 ($55,000 - $47,630) At 20.5 Percent | 1,511 |
| Tax Before Credit | $8,656 |
| Personal Tax Credit | ( 1,810) |
| Tax Payable - Jerri | $6,846 |

The alternative minimum tax is not relevant for Jerri because the income is in the form of interest, not dividends. As Mark would be in a position to use all of his tax credits prior to receiving the additional $55,000 in income, they are not relevant to the determination of his marginal increase in taxes. The federal tax that would be payable on the additional $55,000 received by Mark is as follows:

| | |
|---|---|
| Tax At 20.5 Percent ($95,259 - $48,000 = $47,259 @ 20.5%) | $ 9,688 |
| Tax At 26 Percent ($55,000 + $48,000 - $95,259 = $7,741 @ 26%) | 2,013 |
| Additional Tax Payable - Mark | $11,701 |

The total tax paid by the two children would be $18,547 ($6,846 + $11,701). This is $17,7531 ($36,300 - $18,547) per year less than the amount that would be paid by Sarah without the trust. When combined with a reduction in provincial taxes, the total tax savings could be significantly larger. This should be more than enough to cover the costs of establishing and maintaining this trust.

One tax planning consideration would be to have the trust pay Mark's wife rather than Mark. Since she has no income, her federal tax payable would be the same as in Jerri's calculation. Although Mark would lose the spousal credit in this case, his wife would claim the basic personal credit herself. Despite the fact that having Mark's wife as the beneficiary would result in less taxes being paid, whether this would be advantageous for Mark (and his mother) would also depend on non-tax considerations such as the state of the marriage.

## Self Study Solution Nineteen - 1

### *Case A*

1. The settlor has deemed proceeds of disposition of the fair market value of $26,400, and will record a taxable capital gain of $1,550 [(1/2)($26,400 - $23,300)]. In addition, there will be recapture of CCA of $7,900 ($23,300 - $15,400).
2. The trust acquires the property at a deemed capital cost of $26,400. However, for purposes of calculating CCA and recapture, the ITA 13(7)(e) rules for non-arm's length transactions apply and the value will be $24,850 [$23,300 + (1/2)($26,400 - $23,300)].

### *Case B*

1. The settlor has deemed proceeds of disposition of the fair market value of $15,200. This would result in the settlor having recapture of $2,800 ($15,200 - $12,400).
2. The asset would be recorded in the trust records at the settlor's capital cost of $19,500, with deemed CCA of $4,300, resulting in a UCC of $15,200.
3. When the asset is transferred to the capital beneficiary, the deemed proceeds to the trust will be the UCC at the date of distribution of $13,600, resulting in no gain or loss on the transfer. The beneficiary will be deemed to have acquired the property for the UCC amount of $13,600. However, the beneficiary will have a capital cost of $19,500 for subsequent recapture and capital gains calculation purposes.

### *Case C*

1. Under the general ITA 70(6) rollover provision, the deemed proceeds to the decedent would be the property's cost of $18,200, resulting in no gain or loss on the transfer. As the deceased has net capital loss carry forwards, a better alternative would be to elect out of ITA 70(6) and transfer the property at its fair market value of $76,400. The loss carry forwards could then be used to eliminate taxation on the resulting taxable capital gain of $29,100 [(1/2)($76,400 - $18,200)].

   Note that in the year of death, net capital loss carry forwards can be deducted against any type of income. If the decedent has other income against which the net capital loss carry forward can be deducted, it may not be advantageous to elect out of the rollover. More information on the spouse's current and future taxable income would be needed to optimize the use of the net capital loss carry forward.

2. Under the general ITA 70(6) rollover provision, the trust would record the property at the decedent's cost of $18,200. If the fair market value election is made, the spousal trust will have acquired the property at a deemed cost of $76,400. This higher value will serve to reduce any future gain on the property when it is sold.

***Case D***

1. The settlor has deemed proceeds of disposition of the fair market value of $123,200 and will record a taxable capital gain of $18,900 [(1/2)($123,200 - $85,400)].
2. The trust will record the property at a deemed cost equal to the fair market value of $123,200.

***Case E***

1. The settlor has deemed proceeds of disposition of the fair market value of $51,600 and will record a taxable capital gain of $4,200 [(1/2)($51,600 - $43,200)].
2. The asset would be recorded in the trust records at the fair market value of $51,600.
3. When the asset is transferred to the capital beneficiary, the deemed proceeds to the trust will be the carrying value of $51,600, resulting in no gain or loss on the transfer. The beneficiary will be deemed to have acquired the property at a cost of $51,600.

***Case F***

1. The deemed proceeds for the settlor would be the tax cost of $14,200, resulting in no gain or loss on the transfer.
2. The trust acquires the property at a deemed cost of $14,200.

## Self Study Solution Nineteen - 2

***Part A - Taxable Income For The GRE And Its Beneficiaries***

The payments made by the GRE administrator will result in the following amounts of Taxable Income for the GRE and the two children:

| | Daughter (30%) | Son (50%) | GRE (20%) |
|---|---|---|---|
| Eligible Dividends Received | $26,100 | $43,500 | $17,400 |
| Gross Up Of 38 Percent | 9,918 | 16,530 | 6,612 |
| British Interest (Gross Amount Of $110,000) | 33,000 | 55,000 | 22,000 |
| Net Rental Income ($21,000) | 6,300 | 10,500 | 4,200 |
| Net And Taxable Income | $75,318 | $125,530 | $50,212 |
| British Taxes Paid* ($16,500) | $ 4,950 | $ 8,250 | $ 3,300 |

*The net interest receipt of $93,500 equals 85 percent of $110,000 ($93,500 ÷ 85%). This means that the taxes withheld totaled $16,500 [(15%)($110,000)].

***Part B - Federal Tax Payable For The GRE***

Income that remains in a GRE is taxed using the same rates as would be applicable to an individual. However, the GRE would not be able to claim personal tax credits under ITA 118 to reduce the amount of Tax Payable.

The after tax income of the GRE can be distributed tax free to the beneficiaries of the GRE.

Federal Tax Payable for the GRE would be calculated as follows:

| | |
|---|---|
| Federal Tax Payable: | |
| On First $47,630 | $7,145 |
| On Remaining $2,582 ($50,212 - $47,630) At 20.5 Percent | 529 |
| Federal Tax Payable Before Credits | $7,674 |
| Federal Dividend Tax Credit [(6/11)($6,612)] | ( 3,607) |
| Foreign Tax Credit (See Note) | ( 3,300) |
| Federal Tax Payable | $ 767 |

**Note** The amount that can be deducted for the foreign tax credit is the lesser of the $3,300 of foreign taxes withheld and an amount determined by the following formula:

[(Foreign Non-Business Income ÷ Adjusted Net Income)(Tax Payable Before Credits)]

= [($22,000 ÷ $50,212)($7,674)]

= $3,362

As this amount is more than the actual foreign taxes of $3,300 allocated to the GRE, the actual foreign taxes paid would be the lesser amount, and would be the foreign tax credit.

Note that, if the foreign taxes withheld had exceeded 15 percent of the gross amount of foreign income, the excess would have been deductible under ITA 20(11), rather than added to the amount of foreign tax withheld in the formula.

## Self Study Solution Nineteen - 3

### *Parts A And B - Alternative One*

The following tables assume that one-half of the dividend income will remain in the GRE. They provide the required information on Taxable Income and Tax Payable for the relevant taxation years:

| **Income Allocation** | **GRE** | **Rowena** | **Roger** |
|---|---|---|---|
| Business Income | $ Nil | $12,000 | $ 8,000 |
| Interest | Nil | 1,800 | 1,200 |
| Non-Eligible Dividends Received | 25,000 | 15,000 | 10,000 |
| Dividend Gross Up (15%) | 3,750 | 2,250 | 1,500 |
| Net Rental Income (Note) | Nil | 2,400 | 1,600 |
| Net Income And Taxable Income | $28,750 | $33,450 | $22,300 |
| | | | |
| Federal Income Tax At 15 Percent | $ 4,313 | $5,018 | $ 3,345 |
| Basic Personal Credit | N/A | ( 1,810) | ( 1,810) |
| Federal Dividend Tax Credit | | | |
| [(9/13)(Gross Up)] | ( 2,596) | ( 1,558) | ( 1,038) |
| Federal Tax Payable (Total = $3,864) | $ 1,717 | $1,650 | $ 497 |

**Note** The $4,000 net rental income is calculated as the rent receipts of $12,000, less the operating expenses of $6,000 and CCA of $2,000. The CCA is claimed at the GRE level.

### *Parts A And B - Alternative Two*

The following income allocation assumes that all of the GRE's income will be allocated to Rowena and Roger. This means that the Taxable Income and federal Tax Payable of the GRE will be nil. The calculations for Rowena and Roger for the year ending December 31, 2019 are as follows:

| Income Allocation | Rowena | Roger |
|---|---|---|
| Business Income | $12,000 | $ 8,000 |
| Interest | 1,800 | 1,200 |
| Non-Eligible Dividends Received | 30,000 | 20,000 |
| Dividend Gross Up (15%) | 4,500 | 3,000 |
| Net Rental Income | 2,400 | 1,600 |
| Net And Taxable Income | $50,700 | $33,800 |

| | | |
|---|---|---|
| Federal Income Tax: | | |
| Roger: [(15%)($33,800)] | | $5,070 |
| Rowena: On First $47,630 At 15 Percent | $7,145 | |
| Rowena: On Remaining $3,070 ($50,700 - $47,630) At 20.5 Percent | 629 | |
| Basic Personal Credit | ( 1,810) | ( 1,810) |
| Federal Dividend Tax Credit [(9/13)(Gross Up)] | ( 3,115) | ( 2,077) |
| Federal Tax Payable (Total = $4,032) | $2,849 | $1,183 |

***Part C - Comparison***

The total federal Tax Payable in Alternative Two is $168 ($4,032 - $3,864) higher than the total in Alternative One. This difference reflects the fact that in Alternative Two, $3,070 of the total income was taxed at 20.5 percent, while in Alternative One, all of the income was taxed at 15 percent [(20.5% - 15%)($3,070)] = $169. ($1 rounding difference.)

## Self Study Solution Nineteen - 4

***Part A - Calculation Of Taxable Income***

All amounts are allocated 45 percent to Jessica Jurgens, 40 percent to Joseph Jurgens, and 15 percent to the trust. The Taxable Income of the two beneficiaries and the trust would be calculated as follows:

| | Jessica (45%) | Joseph (40%) | Trust (15%) |
|---|---|---|---|
| Interest On GICs | $ 56,700 | $ 50,400 | $ 18,900 |
| Eligible Dividends Received | 207,900 | 184,800 | 69,300 |
| Gross Up Of 38 Percent | 79,002 | 70,224 | 26,334 |
| Taxable Capital Gain On Land [(1/2)($250,000 - $85,000)] | 37,125 | 33,000 | 12,375 |
| Taxable Capital Gain On Building [(1/2)($962,000 - $725,000)] | 53,325 | 47,400 | 17,775 |
| Net Rental Income (Note) | 63,000 | 56,000 | 21,000 |
| Net And Taxable Income | $497,052 | $441,824 | $165,684 |

**Note** The net rental income, including the recapture of CCA, can be calculated as follows:

| | | |
|---|---|---|
| Revenues From Rental Property | | $125,000 |
| Cash Expenses On Rental Property | | ( 83,000) |
| Recapture Of CCA: | | |
| Capital Cost Of The Building | $725,000 | |
| UCC | ( 627,000) | 98,000 |
| Net Rental Income, Including Recapture | | $140,000 |

***Part B - Tax Payable For The Trust***

The federal Tax Payable for the trust is as follows:

| | |
|---|---|
| Federal Tax Before Credits [(33%)($165,684)] | $54,676 |
| Federal Dividend Tax Credit [(6/11)($26,334)] | ( 14,364) |
| Federal Tax Payable | $40,312 |

As this trust is an inter vivos trust, all of its income is subject to federal tax at 33 percent [ITA 122(1)].

## Self Study Solution Nineteen - 5

A. It is an inter vivos trust. In less technical terms, it could also be described as a family trust in that all of the beneficiaries are family members. In addition, it could be referred to as partially discretionary in that the trustee determines the timing of the income payments.

B. As the trust is an inter vivos trust, the year end will have to be December 31 of each year.

C. All of the income that is allocated to Mr. Dion will be subject to the income attribution rules. As a consequence, it will be included in the Net Income For Tax Purposes of Mrs. Dion. This includes interest, dividends, and capital gains earned by the trust.

   As the twins are over the age of 17, the attribution rules will not apply to their share of the trust's income. This means that the income that is allocated to them will be reported as a part of their Net Income For Tax Purposes.

   As all of the trust's income is either attributed back to Mrs. Dion or allocated to beneficiaries, the trust's Net Income For Tax Purposes will be nil.

D. The answer here will depend on the terms of the loan to the trust as the rules for non-arm's length loans apply. If it is an interest free loan, the results will be the same as in Part C. That is, the income allocated to Mr. Dion will be attributed back to Mrs. Dion, while the income allocated to the twins will be included in their Net Income For Tax Purposes. This would also be the result if the interest rate on the loan was less than the prescribed rate.

   Alternatively, if the loan paid interest at the prescribed rate or higher, the income attribution rules would not apply and the trust income allocated to Mr. Dion would be taxed in his hands. Note that the loan would have to have bona fide repayment terms and the interest would have to be paid within 30 days of the end of each calendar year.

E. ITA 74.5(3) indicates that the income attribution rules do not apply to any income or loss from property that relates to the period throughout which the individuals are living separate and apart because of a breakdown of their marriage or common-law partnership. The attribution rules do not apply to income that accrues subsequent to a separation.

## Self Study Solution Nineteen - 6

### *Part A - Trust For Daughter*

The first trust created is a testamentary trust for the benefit of Mrs. Turner's daughter, Melanie. When there is a transfer of assets at death to any taxpayer other than a spouse or a spousal trust, there is a deemed disposition with proceeds equal to fair market value. Capital gains on all of the assets transferred would need to be realized along with recapture of CCA on the warehouse building.

The principal residence exemption could be used to eliminate the $165,000 [($120,000 - $20,000) + ($145,000 - $80,000)] capital gain on the principal residence. Melanie will not have a taxable benefit from use of the residence. However, since the trust pays for the upkeep and maintenance of the residence, the trust can deduct the costs and they are taxable as income to Melanie.

The capital gain and recapture on the disposition of the warehouse building would be included in Mrs. Turner's final tax return. The taxable capital gain on the warehouse land is $10,000 [(1/2)($75,000 - $55,000)]. As the fair market value of the warehouse is equal to its capital cost, there is no capital gain on the warehouse building. However, there would be $40,000 ($85,000 - $45,000) of recaptured CCA. This amount would be included in Mrs. Turner's final tax return.

The trust will be deemed to acquire all of the assets at their fair market values. In the case of the warehouse land, the adjusted cost base will be the fair market value of $75,000. In the case of the warehouse building, the capital cost and the new UCC will be the fair market value of $85,000 which is equal to its original cost.

### *Part A - Trust For Husband*

The second trust appears to be a qualifying spousal trust. Where there is a transfer at death to a qualifying spousal trust, the transfer is deemed to be a disposition with proceeds equal to the deceased taxpayer's tax cost. This would be the capital cost of the cottage and stock portfolio and, as a consequence of using this value, the transfer of assets to the trust will have no tax consequences for Mrs. Turner's final tax return.

The trust will be deemed to have acquired all of the assets at the same capital cost values that were used as proceeds of disposition by Mrs. Turner.

### *Part B - Death Of Husband*

Unless Mr. West has remarried with great haste and can pass these assets on to a new spouse or qualifying spousal trust, his death will result in a deemed disposition of the trust's assets for proceeds equal to fair market value. In the case of the cottage, there is a capital gain of $170,000 [($200,000 - $40,000) + ($122,000 - $112,000)], one-half, or $85,000 of which is taxable. On the stock market portfolio there will be a taxable capital gain of $30,000 [(1/2)($280,000 - $220,000)].

Mr. West's death would have no effect on Mrs. Turner's final return or tax effect on Melanie. Of course if Melanie is a beneficiary in Mr. West's will, his death will result in additional income and income tax for Melanie in the future, but this information is not in the problem.

### *Part C - Graduated Rate Estate*

The principal advantage of a Graduated Rate Estate is that any income that is not distributed is taxed at graduated rates, rather than at the maximum federal rate of 33 percent. As the problem does not state the marginal tax rates for either Mr. Turner or Melanie, we cannot determine whether or not this would be advantageous. If either of their marginal rates are above the minimum 15 percent rate, GRE status for the income producing properties could be advantageous.

Given Mr. West's short remaining life, any benefits from the GRE would be quite limited in his case.

## Chapter 19 Learning Objectives

After completing Chapter 19, you should be able to:

1. Explain the basic concepts of trusts (paragraph [P hereafter] 19-1 to 19-16).
2. Explain the difference between a trust and an estate, including the concept of a GRE (P 19-17 to 19-23).
3. Describe the procedures required to establish a trust (P 19-24 to 19-27).
4. Describe the procedures applicable to the filing of trust tax and information returns (P 19-28 to 19-29).
5. List the major non-tax reasons for using trusts (P 19-30 and 19-31).

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6. Describe the different classifications of trusts (P 19-32 to 19-51).
7. Explain the basic model for the taxation of trusts (P 19-52 and 19-55).
8. Describe the rollovers available for contributions to a trust (P 19-56 to 19-68).
9. Describe the rollovers available to transfer assets to the capital beneficiaries of a trust (P 19-69 to 19-74).
10. Apply the deemed disposition rules after a trust has existed for 21 years and on the death of a settlor of an alter ego trust or survivor spouse of a qualifying spousal trust (P 19-75 to 19-78).

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11. Calculate the Net Income For Tax Purposes and Taxable Income of a trust (P 19-79 to 19-92).
12. Describe the provisions relating to income allocations to beneficiaries (P 19-93 to 19-112).
13. Calculate the Tax Payable for testamentary and inter vivos trusts (P 19-113 to 19-125).
14. Explain how the income attribution rules may be applicable to trusts and describe any related tax planning considerations (P 19-126 to 19-131).
15. Explain the tax treatment of the purchase and sale of an interest in a trust (P 19-132 to 19-137).

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16. Describe the major tax planning factors that should be considered when evaluating various types of trusts such as family, spousal and alter ego (P 19-138 to 19-151).
17. List the non-tax and tax considerations that should be considered in estate planning (P 19-152 to 19-156).
18. Explain the objectives of an estate freeze (P 19-157 and 19-158).
19. Describe the estate freeze techniques that do not involve rollovers (P 19-159 to 19-166).
20. Describe the application of an ITA 86(1) share exchange to implement an estate freeze (P 19-167 to 19-175).
21. List the major considerations involved in choosing between a Section 85 and Section 86 rollover when implementing an estate freeze (P 19-176 to 19-178).

# CHAPTER 20

## How To Work Through Chapter 20

We recommend the following approach in dealing with the material in this Chapter:

**Subjects Covered In Chapter**

- Read paragraph 20-1 to 20-5 (in the textbook).

**Part I Tax On Non-Residents - Introduction**

- Read paragraph 20-6 to 20-14.

**Non-Residents Carrying On Business In Canada - Part I Tax**

- Read paragraph 20-15 to 20-20.
- Do Exercise Twenty-1 and check the solution in this Study Guide.

**Non-Residents Earning Employment Income In Canada - Part I Tax**

- Read paragraph 20-21 to 20-25.
- Do Exercises Twenty-2 and Twenty-3 and check the solutions in this Study Guide.

**Non-Residents Disposing Of Taxable Canadian Property - Part I Tax**

- Read paragraph 20-26 to 20-30.
- Do Exercise Twenty-4 and check the solution in this Study Guide.
- Do Self Study Problem Twenty-1 and check the solution in this Study Guide.

**Part XIII Tax On Non-Residents - Introduction And Applicability**

- Read paragraph 20-31 to 20-37.

**Interest Income Earned By Non-Residents - Part XIII Tax**

- Read paragraph 20-38 to 20-41.
- Do Exercise Twenty-5 and check the solution in this Study Guide.

**Dividend, Royalty And Rental Income Earned By Non-Residents - Part XIII Tax**

- Read paragraph 20-42 to 20-52.
- Do Exercise Twenty-6 and check the solution in this Study Guide.

**Pension And Other Benefits Earned By Non-Residents - Part XIII Tax**

- Read paragraph 20-53 to 20-62.
- Do Self Study Problem Twenty-2 and check the solution in this Study Guide.

**Entering Canada - Immigration**

- Read paragraph 20-63 to 20-65.

### Departing From Canada - Emigration

- Read paragraph 20-66.
- Do Exercises Twenty-7 and Twenty-8 and check the solutions in this Study Guide.
- Read paragraph 20-67 to 20-74.
- Do Exercise Twenty-9 and check the solution in this Study Guide.
- Read paragraph 20-75 to 20-79.
- Do Self Study Problem Twenty-3 and check the solution in this Study Guide.
- Read paragraph 20-80 to 20-87.
- Do Exercise Twenty-10 and check the solution in this Study Guide.

### Foreign Source Income Of Canadian Residents - Introduction

- Read paragraph 20-88 to 20-90.

### Foreign Source Income Of Canadian Residents - Reporting Requirements (T1135)

- Read paragraph 20-91 to 20-98.
- Do Exercise Twenty-11 and check the solution in this Study Guide.
- Do Self Study Problem Twenty-4 and check the solution in this Study Guide.

### Foreign Source Employment Income Of Canadian Residents

- Read paragraph 20-99 to 20-100.
- Do Self Study Problem Twenty-5 and check the solution in this Study Guide.

### Foreign Source Unincorporated Business Income Of Canadian Residents

- Read paragraph 20-101 to 20-103.
- Do Exercise Twenty-12 and check the solution in this Study Guide.

### Foreign Source Interest Income And Capital Gains Of Canadian Residents

- Read paragraph 20-104 to 20-107.

### Foreign Source Dividend Income Of Canadian Residents - Including From Foreign Affiliates And FAPI

- Read paragraph 20-108 to 20-120.
- Do Self Study Problem Twenty-6 and check the solution in this Study Guide.
- Read paragraph 20-121 to 20-125.
- Do Exercise Twenty-13 and check the solution in this Study Guide.
- Read paragraph 20-126 to 20-151.
- Do Exercise Twenty-14 and check the solution in this Study Guide.
- Read paragraph 20-152 and 20-153.
- Do Exercise Twenty-15 and check the solution in this Study Guide.
- Do Self Study Problem Twenty-7 and check the solution in this Study Guide.

### To Complete This Chapter

- If you would like more practice in problem solving, do the Supplementary Self Study Problems for the chapter. These problems and solutions are available on MyLab.
- Review the Key Terms Used In This Chapter in the textbook at the end of Chapter 20. Consult the Glossary for the meaning of any key terms you do not know.
- Test yourself with the Chapter 20 Glossary Flashcards available on MyLab.
- Ensure you have achieved the Chapter 20 Learning Objectives listed in this Study Guide.
- As a review, we recommend you view the PowerPoint presentation for Chapter 20 that is on MyLab.

### Practice Examination

- Write the Practice Examination for Chapter 20 that is on MyLab. Mark your examination using the Practice Examination Solution that is on MyLab.

## Solutions to Chapter Twenty Exercises

### *Exercise Twenty - 1 Solution*

**Case 1** Jazzco is not carrying on business in Canada and would not be subject to Canadian taxes.

**Case 2** Jazzco is carrying on business in Canada in a permanent establishment located in Toronto. Therefore, Jazzco is taxable in Canada under ITA 2(3) on the profits attributable to the Canadian factory.

**Case 3** The tax treaty allows Canada to tax business income only if such income is attributable to a permanent establishment in Canada. The warehouse constitutes a fixed place of business regardless of whether it is owned or leased. However, since it appears to be used exclusively to maintain an inventory for delivery, under the Canada/U.S. tax treaty, it would be an excluded facility and would not be considered to be a permanent establishment. Jazzco would not be taxable under ITA 2(3) on its Canadian profits. The fact that the employee acts on behalf of the non-resident employer would not alter the conclusion since the employee does not have the authority to conclude contracts.

**Case 4** In this Case, because the employee has authority to conclude contracts on behalf of a non-resident enterprise, the employee is deemed to be a permanent establishment. This means that Jazzco is taxable in Canada under ITA 2(3) on its business profits attributable to the permanent establishment (i.e., the employee).

**Case 5** Since the warehouse is not used exclusively for maintaining an inventory, the permanent establishment exception in the tax treaty would not apply with the result that profits attributable to that warehouse would be taxable in Canada.

### *Exercise Twenty - 2 Solution*

Dawn is an individual who has become a resident of another country, but continues to receive remuneration from a resident Canadian taxpayer. Given that the tax treaty exempts her salary from taxation in Egypt, ITA 115(2) deems her to be employed in Canada and, as a consequence, she would be subject to Canadian taxes on her salary.

### *Exercise Twenty - 3 Solution*

**Case 1** The employment income is taxable in Canada. The Canada/U.S. tax treaty allows Canada to tax employment income earned in Canada unless either of two exceptions is applicable. The first exception is the $10,000 rule. This exception however does not apply since David earned $11,200 Canadian in 2019 [($2,800)(4 months)]. The second exception is the 183 day rule. Although David was in Canada for only 122 days during 2019 and therefore met the first part of the test, he failed the remaining part of the test since the employer was a Canadian resident and could deduct the payments.

**Case 2** The employment income is not taxable in Canada. The 183 day rule exempts the income from Canadian taxation because the employer was not resident in Canada, did not have a permanent establishment in Canada, and could not deduct the payments for Canadian tax purposes.

**Case 3** The employment income is taxable in Canada. The Canada/U.S. tax treaty would exempt the income from Canadian tax if the amount was less than $10,000 Canadian, or if Sandra spent less than 183 days in Canada in any 12 month period beginning or ending in 2019. As she earned $50,000 Canadian and spent 238 days at her job in Canada, neither of these exceptions are applicable.

### Exercise Twenty - 4 Solution

**Case 1** Nancy is not taxable on the gain. As a non-resident, Nancy is only taxable in Canada on the disposition of taxable Canadian property. Shares of a resident public company are only taxable Canadian property if Nancy had owned more than 25 percent of the issued shares of any class of the company in the 60 months preceding the disposition.

**Case 2** Joe is taxable on the gain. The condo is taxable Canadian property since it is real property (e.g. land and buildings) situated in Canada. The Canada/U.S. tax treaty gives Canada the right to tax such gains. The property is not exempt from Canadian tax as a principal residence since Joe did not acquire the condo for his own habitation.

**Case 3** Joe would be taxable on the gain on the shares. Shares of an unlisted corporation are taxable Canadian property if at any time within the preceding 60 months more than 50 percent of the fair market value of the company is derived from Canadian real property. In addition, the Canada/U.S. tax treaty allows Canada to tax the gain on the disposition of shares if the corporation is resident in Canada and the value of the shares is derived principally from real property situated in Canada.

**Case 4** Joe would not be taxable on the gain on the shares. The shares are taxable Canadian property because they represent shares of an unlisted non-resident corporation that, at some time in the 60 months preceding the disposition, derived more than 50 percent of their value from taxable Canadian property. However, the Canada/U.S. tax treaty does not list this as one of the items where Canada is allowed to tax U.S. residents.

### Exercise Twenty - 5 Solution

**Case 1** As Jason is at arm's length from the bank and the interest is not participating debt interest, he would not be subject to Part XIII tax.

**Case 2** As Janice is at arm's length with the Canadian government and the interest is not participating debt interest, the interest would not be subject to Part XIII tax. Note that interest on Government Of Canada bonds is fully exempt interest, but this fact does not affect the result in this case.

**Case 3** As Julian is at arm's length from the bank and the interest is not participating debt interest, he would not have to withhold Part XIII tax.

**Case 4** The Canada/U.S. tax treaty exempts U.S. residents from Part XIII tax. This means that Jasmine does not have to withhold Part XIII tax despite the fact that her brother is a non-arm's length party.

### Exercise Twenty - 6 Solution

**Case 1** Rentco appears to be carrying on business in Canada through a permanent establishment. As a result, no Part XIII tax is payable. However, Rentco would be subject to Part I tax on its income attributable to the permanent establishment in Saskatchewan.

**Case 2** Jack would be subject to Part XIII tax of $10,500 [(25%)($42,000)]. This represents an effective tax rate of 37.5 percent on his net rental income of $28,000. Alternatively, Jack could elect under ITA 216 to be taxed under Part I on the net rental income of $28,000 ($42,000 - $14,000). Whether this is would be a good alternative depends on Jack's marginal tax rate. The break-even rate would be 37.5 percent ($10,500 ÷ $28,000). If his marginal rate is below this, taxation under Part I would be the better alternative. If his marginal rate exceeds 37.5 percent, taxation under Part XIII would be preferable.

**Case 3** Jack would be subject to Part XIII tax on the gross rents received for the boats unless he would be considered to be carrying on a business. However, the Canada/U.S. tax treaty reduces the withholding tax to 10 percent of the gross rents received, or $800. Note that Jack would not be eligible to elect under ITA 216 to be taxed under Part I on the boat rents, since this election is generally restricted to real property.

### Exercise Twenty - 7 Solution

There would be a deemed disposition on her departure, leaving her liable for the taxes on a $10,500 [(1/2)($49,000 - $28,000)] taxable capital gain.

### Exercise Twenty - 8 Solution

As real property is exempt from the deemed disposition provision contained in ITA 128.1(4)(b), there would be no tax consequences with respect to the rental property at the time of Mr. Chrysler's departure. However, real property is Taxable Canadian Property and, as a consequence, he would be liable for Canadian taxes on both recapture and capital gains resulting from a subsequent sale of the property, even though he will be a non-resident.

### Exercise Twenty - 9 Solution

With respect to the shares of the Canadian private company, there would be a required deemed disposition, resulting in a taxable capital gain of $57,500 [(1/2)($235,000 - $120,000)]. In the absence of an election on the rental property, this would be the only tax consequence resulting from her departure.

However, if Ms. Lopez elects under ITA 128.1(4)(d) to have a deemed disposition on her rental property, the results will be as follows:

| | |
|---|---|
| Deemed Proceeds Of Disposition For Land | $30,000 |
| Adjusted Cost Base | ( 60,000) |
| Capital Gain (Loss) On Land | ($30,000) |

| | |
|---|---|
| UCC Of Building | $142,000 |
| Lesser Of: | |
| Capital Cost = $160,000 | |
| Deemed Proceeds Of Disposition = $100,000 | ( 100,000) |
| Terminal Loss | $42,000 |

The net result would be as follows:

| | |
|---|---|
| Taxable Capital Gain On Shares | $57,500 |
| Allowable Capital Loss On Land [(1/2)($30,000)] | ( 15,000) |
| Terminal Loss On Building | ( 42,000) |
| Net Income Inclusion | $ 500 |

### Exercise Twenty - 10 Solution

In the absence of ITA 128.1(4)(b)(iv), there would be a deemed disposition of both the U.K. shares and the Canadian shares at the time of Mr. Brookings' departure from Canada. As it appears that he has been in Canada for less than 60 months in the last 10 years, there will be no deemed disposition of the U.K. shares that he owned prior to his arrival in Canada. There will, however, be a deemed disposition of the Canadian shares acquired during his stay in Canada. This will result in a taxable capital gain of $8,500 [(1/2)($92,000 - $75,000)].

There will be no deemed disposition of the vacant Canadian land because real property is exempt from the deemed disposition requirement of ITA 128.1(4)(b). Note, however, that vacant land is Taxable Canadian Property. This means that any gain resulting from its disposition will be subject to Canadian taxes, without regard to whether the vendor is a Canadian resident.

### Exercise Twenty - 11 Solution

The cost of Simon's foreign investments total £197,000 (£52,000 + £145,000) which put him over the $100,000 Canadian reporting limit [(£197,000)($1.70) = $334,900] for filing Form T1135 and over the $250,000 limit for the simplified method. He is required to report the following information on the T1135:

**Funds Held Outside Canada**

- The name of the bank that holds the funds - Bank of Scotland
- The country code for the country of residence of the bank (Scotland) - GBR (Available from the CRA website)
- The maximum amount of funds held during the year - $88,400 [(£52,000)($1.70)]
- The funds held at year end - $69,700 [(£41,000)($1.70)]
- Income from the property - $1,700 [(£1,000)($1.70)]

**Indebtedness Owed By A Non-Resident**

- A description of the indebtedness - Interest free loan to brother-in-law
- The country code for the non-resident issuer's country of residence (Scotland) - GBR (Available from the CRA website)
- The maximum cost amount during the year - $246,500 [(£145,000)($1.70)]
- The year end cost amount - $246,500 [(£145,000)($1.70)]
- The income or loss - Nil
- The gain or loss on disposition - N/A

### Exercise Twenty - 12 Solution

The gross amount of the U.S. business income will be subject to tax in Canada. Jason's foreign business income tax credit is $1,800, the lesser of the $1,800 foreign tax withheld and $3,780 [($18,000 ÷ $100,000)($21,000)].

The required solution would be as follows:

| | |
|---|---|
| Gross Foreign Business Income | $18,000 |
| Canadian Tax Rate | 44% |
| Canadian Tax Payable Before Credit | $ 7,920 |
| Foreign Tax Credit = Foreign Tax Withheld | ( 1,800) |
| Net Canadian Tax Payable | $ 6,120 |
| Foreign Tax Withheld | 1,800 |
| Total Taxes Payable | $ 7,920 |

Based on these figures, his after tax retention and overall tax rate on his foreign source income would be as follows:

| | |
|---|---|
| After Tax Retention ($18,000 - $7,920) | $10,080 |
| Overall Tax Rate ($7,920 ÷ $18,000) | 44% |

### Exercise Twenty - 13 Solution

**Forco 1** Canvest has the required 1 percent investment and, with its related subsidiary, has the required 10 percent investment. Forco 1 is a foreign affiliate.

**Forco 2** Canvest has the required 1 percent investment. However, as it is not related to any of the other shareholders, the 10 percent test is not met. This means that Forco 2 is not a foreign affiliate.

**Forco 3** Canvest has the required 1 percent investment and, with the controlling shareholder's spouse (a related person), has the required 10 percent investment. Forco 3 is a foreign affiliate.

### *Exercise Twenty - 14 Solution*

Since Forco is a controlled foreign affiliate of Canco, Canco must accrue its proportionate share (100%) of Forco's investment income. The required calculations are as follows:

| | |
|---|---|
| FAPI [ITA 91(1)] | $100,000 |
| Deduct Lesser Of: | |
| • FAPI = $100,000 | |
| • ITA 91(4) Deduction [(4)(18%)($100,000)] | ( 72,000) |
| Net Addition To Net Income For Tax Purposes | $ 28,000 |

### *Exercise Twenty - 15 Solution*

| | |
|---|---|
| Foreign Source Dividend – ITA 90(1) | $82,000 |
| Deduct Lesser Of: | |
| • Previous FAPI After ITA 91(4) Deduction = $28,000 | |
| • Dividend Received = $82,000 | ( 28,000) |
| Net Addition To Net Income For Tax Purposes | $54,000 |

Note that the additions to Net Income For Tax Purposes for the two years total $82,000 ($28,000 + $54,000). This is equal to the $100,000, less the $18,000 in taxes paid in the foreign jurisdiction. Had there been any withholding taxes on the dividend, they would not have been eligible for a foreign tax credit.

While this is not a required part of the problem, you should note that Taxable Income and Tax Payable would be nil in this example. There would be a deduction under ITA 113(1)(b) equal to $54,000 [($18,000)(4 - 1). The resulting Taxable Income of nil reflects the fact that on Forco's income of $100,000, taxes at the usual Canadian rate of 25 percent have already been paid. This $25,000 [(25%)($100,000)] is made up of the $18,000 [(18%)($100,000)] paid by Forco in the foreign jurisdiction, plus the $7,000 [(25%)($28,000)] of Canadian taxes on Canco's 2019 addition to Net Income For Tax Purposes.

## Self Study Solution Twenty - 1

### *Case A*

As Sharon is earning employment income in Canada, she would generally be taxable under ITA 2(3). With respect to the Canada/U.S. tax treaty provisions, while her income exceeds $10,000, her stay in Canada is less than 183 days. However, her employment income would be deductible by the payor Canadian corporation. This means that Sharon would be subject to Part I tax on her Canadian employment income.

### *Case B*

As Mariah is earning employment income in Canada, she would generally be taxable under ITA 2(3). With respect to the Canada/U.S. tax treaty provisions, while her income exceeds $10,000, her stay in Canada is less than 183 days. In addition, the payor is not a Canadian entity that will be able to deduct these payments against Canadian taxes. Given this, Mariah would be exempt from Part I tax under the provisions of the Canada/U.S. tax treaty.

### *Case C*

With respect to private companies incorporated in Canada if, within the preceding 60 month, more than 50 percent of their value is derived from Canadian real property, their shares are considered to be Taxable Canadian Property. This means that gains on the sale of such shares would be taxable under ITA 2(3). While the Canada/U.S. tax treaty serves to exempt gains on certain types of Taxable Canadian Property (generally, shares that during the last five years did not derive their value largely from Canadian real property), shares of Canadian incorporated private companies is not on this list. Therefore, Part I tax would be applicable on the gain.

### Case D

Shares of unlisted companies are viewed as Taxable Canadian Property if, within the preceding 60 months, more than 50 percent of their value is derived from Canadian real property. This means that Rae's shares would be considered Taxable Canadian Property and the gain would be considered taxable under ITA 2(3). However, Rae's corporation is not a "Canadian" corporation and this means that it is not on the Canada/U.S. tax treaty list of Taxable Canadian Property where gains accruing to U.S. residents are subject to Canadian tax. Therefore, Part I tax would not be applicable on the gain.

### Case E

Under the Canada/U.S. tax treaty, Part I tax is applicable to a U.S. resident only when the business is carried on through a permanent establishment. While the U.S. firm in this Case is carrying on business, it is not through a permanent establishment. The treaty specifically exempts the warehouse as it is used exclusively for holding inventories. In addition, Martha Faulk could not be viewed as a permanent establishment as she does not have authority to conclude individual sales contracts. Part I tax would not be applicable in this case.

### Case F

This Case differs from Case E in that the warehouse is used for more than holding inventories. This means that it is not an excluded facility under the Canada/U.S. treaty. Further, as Martha Faulk has the authority to conclude contracts, she, as a person, would be viewed as a permanent establishment. This means that Orex would be considered to be carrying on business in Canada through a permanent establishment. Therefore, Part I tax would be applicable.

## Self Study Solution Twenty - 2

### Case A

The interest she has received is not from holding participating debt and she is at arm's length with the bank. The interest would not be subject to Part XIII tax.

### Case B

As the amount of interest is calculated on the basis of the corporation's revenues, it would appear that Mark is receiving interest on a participating debt security. The interest would be subject to Part XIII tax.

### Case C

Because the interest is from participating debt, it would normally be subject to Part XIII tax. However, the Canada/U.S. tax treaty exempts U.S. residents from all Canadian taxation on interest income. The interest would not be subject to Part XIII tax.

### Case D

As she is not a resident of a country with which Canada has a tax treaty, Darlene would be subject to Part XIII tax at a rate of 25 percent. Depending on whether she uses the available election to be taxed under Part I, the Tax Payable would be as follows:

| | |
|---|---|
| **Without Election - Part XIII** [(25%)($35,000)] | $8,750 |
| **With Election - Part I** [(15%)(148%*)($35,000 - $27,000)] | $1,776 |

*The 148% reflects the additional federal tax on individual income that is not earned in a province.

The use of the election is clearly desirable in this Case.

### *Case E*

The Canada/U.S. tax treaty reduces the Part XIII rate on rental properties that are not real property from 25 to 10 percent. As Darlene is renting out real property, the 25 percent rate is applicable and the results are the same as Case D. Here again, the use of the election is clearly desirable.

### *Case F*

Dividends from Canadian companies that are received by non-residents are subject to Part XIII tax. Under the Canada/U.S. tax treaty the statutory 25 percent rate is reduced to either 5 percent or 15 percent. Although Brian owns more than 10 percent of the voting shares of the Canadian corporation, he is an individual, not a corporation, so the applicable rate is 15 percent, not 5 percent. Brian's Part XIII tax payable would be $3,300 [(15%)($22,000)].

When an individual leaves Canada, there is a deemed disposition of all property owned at the time of departure at fair market value with certain exceptions. For each of the listed assets, the tax consequences that result from Mr. Rankin's departure are as follows:

**City Home*** Real property situated in Canada is exempted from the deemed disposition rule. There would be no deemed disposition and no tax consequences at the time of Jonathan's departure. However, the city home would be classified as Taxable Canadian Property and, as a result, any gain on the disposition of the property would be subject to Canadian taxation even though Mr. Rankin is no longer a Canadian resident.

**Cottage*** As was the case with the city home, for the cottage there would be no deemed disposition and no tax consequences at the time of Jonathan's departure. However, the cottage would also be classified as Taxable Canadian Property and, as a result, any gain on the disposition of the property would be subject to Canadian taxation even though Mr. Rankin is no longer a Canadian resident.

*While this is not a required part of the solution, we would note that either the city home and/or the cottage could qualify for the principal residence exemption. However, this would require an election for a deemed disposition of the relevant property.

**Automobile** While gains or personal use property are taxable, losses are not deductible. Given this, there would be no tax consequences associated with the deemed disposition of the automobile.

**Cash** There are never any tax consequences associated with dispositions of cash.

**RRSP** As an "excluded right", RRSP assets are exempted from the deemed disposition rule. There would be no deemed disposition of the RRSP assets and no tax consequences when Jonathan departs from Canada. Payments from the RRSP will be taxed under Part XIII when they are withdrawn and remitted to Mr. Rankin as a non-resident.

**Shares In A CCPC** There is no exemption from the deemed disposition rules for any type of shares. There would be a deemed disposition of these shares on Mr. Rankin's departure resulting in a taxable capital gain of $7,500 [(1/2)($80,000 - $65,000)].

**Shares In Public Companies** There would be a deemed disposition of these shares, resulting in a taxable capital gain of $39,000 [(1/2)($120,000 - $42,000)].

## Self Study Solution Twenty - 3

When an individual leaves Canada, there is a deemed disposition of all property owned at the time of departure at fair market value with certain exceptions. For each of the listed assets, the tax consequences that result from Mr. Rankin's departure are as follows:

**City Home*** Real property situated in Canada is exempted from the deemed disposition rule. There would be no deemed disposition and no tax consequences at the time of Jonathan's departure. However, the city home would be classified as Taxable Canadian Property and, as a result, any gain on the disposition of the property would be subject to Canadian taxation even though Mr. Rankin is no longer a Canadian resident.

**Cottage*** As was the case with the city home, for the cottage there would be no deemed disposition and no tax consequences at the time of Jonathan's departure. However, the cottage would also be classified as Taxable Canadian Property and, as a result, any gain on the disposition of the property would be subject to Canadian taxation even though Mr. Rankin is no longer a Canadian resident.

*While this is not a required part of the solution, we would note that either the city home and/or the cottage could qualify for the principal residence exemption. However, this would require an election for a deemed disposition of the relevant property.

**Automobile** While gains or personal use property are taxable, losses are not deductible. Given this, there would be no tax consequences associated with the deemed disposition of the automobile.

**Cash** There are never any tax consequences associated with dispositions of cash.

**RRSP** As an "excluded right", RRSP assets are exempted from the deemed disposition rule. There would be no deemed disposition of the RRSP assets and no tax consequences when Jonathan departs from Canada. Payments from the RRSP will be taxed under Part XIII when they are withdrawn and remitted to Mr. Rankin as a non-resident.

**Shares In A CCPC** There is no exemption from the deemed disposition rules for any type of shares. There would be a deemed disposition of these shares on Mr. Rankin's departure resulting in a taxable capital gain of $7,500 [(1/2)($80,000 - $65,000)].

**Shares In Public Companies** There would be a deemed disposition of these shares, resulting in a taxable capital gain of $39,000 [(1/2)($120,000 - $42,000)].

## Self Study Solution Twenty - 4

1. Foreign investment reporting is not required. Since the cottage is personal use property, the fact that the cost is greater than $100,000 is not relevant. The fair market value is also not relevant.

2. Foreign investment reporting is required as the balance was greater than $100,000 at some point in the year.

3. Foreign investment reporting is not required as the cost of the shares is less than $100,000. The fact that their current fair market value exceeds $100,000 is not relevant.

4. No foreign investment reporting is required as the assets are used in an active business.

## Self Study Solution Twenty - 5

A. Because he is a resident of Canada, the hockey player will have all US$14,000 of hockey school income subject to tax in Canada. With respect to U.S. taxation, he would not have a tax obligation in that country because his total earnings are only $7,000. The Canada/U.S. tax treaty exempts non-residents from U.S. taxation when their earnings in that country are less than $10,000.

B. Because the expert is a resident of Canada, the full $150,000 of income would be subject to tax in Canada. He would not be taxed in the U.S. because the provisions of the Canada/U.S. tax treaty exempt Canadian residents from U.S. taxation provided they are in the U.S. less than 183 days, their employer does not have a permanent establishment in the U.S., and their employer does not deduct the compensation in computing U.S. taxes. The expert was in the U.S. for only 180 days [(3)(60)], and his compensation is paid by a Canadian company.

## Self Study Solution Twenty - 6

The Hispanic Ltd. tax withholding equals 25 percent ($5,750 ÷ $23,000) of the dividend paid. The Deutsch Inc. tax withholding equals 10 percent ($1,400 ÷ $14,000) of the dividend paid. As the foreign non-business tax credit is limited to 15 percent, the additional 10 percent ($2,300) withheld by Foreign Country 1 will have to be deducted in the determination of Mona's Net Income For Tax Purposes.

| | |
|---|---|
| Net Employment Income | $ 87,000 |
| Hispanic Ltd. Gross Dividends (No Gross Up) | 23,000 |
| Deutsch Inc. Gross Dividends (No Gross Up) | 14,000 |
| Excess Withholding [(25% - 15%)($23,000)] | ( 2,300) |
| Net Income For Tax Purposes And Taxable Income | $121,700 |

Using this result, her federal Tax Payable would be calculated as follows:

| | | |
|---|---|---|
| Tax On First $95,259 | | $16,908 |
| Tax On Next $26,441 ($121,700 - $95,259) At 26% | | 6,875 |
| Tax Payable Before Credits | | $23,783 |
| Basic Personal Credit | ($12,069) | |
| EI | ( 860) | |
| CPP | ( 2,749) | |
| Canada Employment | ( 1,222) | |
| Total Credit Amount | ($16,900) | |
| Applicable Rate | 15% | ( 2,535) |
| Tax Otherwise Payable | | $21,248 |
| Foreign Tax Credits (See Note) | | |
| Hispanic Ltd. | | ( 3,450) |
| Deutsch Inc. | | ( 1,400) |
| Federal Tax Payable | | $16,398 |

**Note** The foreign non-business tax credits are calculated on a country by country basis (see Chapter 11).

The tax credit on the Hispanic Ltd. shares would be the lesser of:

- Amount Withheld (Limited To 15%) = [(15%)($23,000)] = $3,450
- $\left[\frac{\text{Foreign Non - Business Income}}{\text{Adjusted Division B Income}}\right](\text{Tax Otherwise Payable})$

$$= \left[\frac{\$23,000}{\$121,700}\right](\$21,248) = \$4,016$$

The tax credit on the Deutsch Inc. shares would be the lesser of:

- Amount Withheld (Less Than 15%) = $1,400
- $\left[\frac{\text{Foreign Non - Business Income}}{\text{Adjusted Division B Income}}\right](\text{Tax Otherwise Payable})$

$$= \left[\frac{\$14,000}{\$121,700}\right](\$21,248) = \$2,444$$

## Self Study Solution Twenty - 7

### *Alta Inc. Dividends*

As BK Inc. owns more than 10 percent of the Alta Inc. shares, Alta Inc. is a foreign affiliate of BK Inc. Alta Inc. is operating in a country with which Canada has a tax treaty. In addition, all of its income is from active business activities. Given this, all of the dividend is being paid from Exempt Surplus. This means that, while the pre-withholding amount of the dividend will be included in Net Income For Tax Purposes, this amount can be deducted in full under ITA 113(1)(a).

### Bolt Ltd. Dividends

While Bolt Ltd. earns all of its income through active business activities, it is not located in a country which has a tax treaty or a TIEA with Canada. Given this, the dividend will be paid from Taxable Surplus. It will be included in Net Income For Tax Purposes and not deductible under ITA 113(1)(a). However, it will be eligible for a deduction under ITA 113(1)(b) for taxes paid by Bolt Ltd. in the foreign jurisdiction, as well as a deduction under ITA 113(1)(c) for taxes withheld on the distribution to BK Inc.

### Taxable Income And Tax Payable Calculation

The required calculations for Taxable Income and Tax Payable would be as follows:

| | |
|---|---|
| Alta Inc. Dividends (Before Withholding) | $ 34,000 |
| Bolt Ltd. Dividends (Before Withholding) | 76,000 |
| Addition To Net Income For Tax Purposes | $110,000 |
| Deductions: | |
| ITA 113(1)(a) Alta Dividends | ( 34,000) |
| ITA 113(1)(b) - Note 1 | ( 12,000) |
| ITA 113(1)(c) - Note 2 | ( 45,600) |
| Taxable Income | $ 18,400 |
| Rate | 25% |
| Canadian Tax Payable | $ 4,600 |

**Note 1** Given Bolt's local tax rate of 5 percent, the pre-tax income that formed the base for the dividend to BK Inc. was $80,000 [$76,000 ÷ (1 - 5%)]. This means that the local taxes paid by Bolt were $4,000 [(5%)($80,000)] and that the ITA 113(1)(b) deduction would be $12,000 [($4,000)(3)]. See the text for an explanation of the relevant factor of 3.

**Note 2** Taxes withheld were $11,400. Given this, the ITA 113(1)(c) deduction is equal to $45,600 [($11,400)(4)]. See the text for an explanation of the relevant factor of 4.

### Verification

As indicated in the text, the goal here is to have foreign affiliate dividends paid from Taxable Surplus subject to total Canadian and foreign taxes at a rate of 25 percent. The preceding calculation has achieved this goal as supported by the following calculations:

| | |
|---|---|
| Bolt's Pre-Tax Income [$76,000 ÷ (1 - 5%)] | $80,000 |
| Rate | 25% |
| Total Tax At 25% Rate | $20,000 |

| | |
|---|---|
| Foreign Tax Paid On Bolt's Income [(5%)($80,000)] | $ 4,000 |
| Taxes Withheld From Dividend | 11,400 |
| Canadian Tax Payable | 4,600 |
| Total Tax Paid | $20,000 |

## Chapter 20 Learning Objectives

After completing Chapter 20, you should be able to:

1. Describe the role of international tax treaties (paragraph [P hereafter] P 20-1 to 20-5).
2. Describe the liability for Part I tax of non-residents earning Canadian source income from business, employment and the disposition of taxable Canadian property (P 20-6 to 20-30).
3. Describe the liability for Part XIII tax of non-residents earning Canadian source property income including income from interest, dividends, royalties, rents and pensions (P 20-31 to 20-62).
4. Describe the deemed disposition/reacquisition provisions related to immigration to Canada (P 20-63 to 20-65).
5. Describe the tax provisions related to emigration from Canada, including those related to elective dispositions and security for departure tax (P 20-66 to 20-79).

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6. Describe the provisions available for unwinding a deemed disposition on departure from Canada (P 20-80 to 20-84).
7. Explain the rules applicable to short-term residents of Canada (P 20-85 to 20-87).
8. Describe the foreign investment reporting requirements of form T1135 (P 20-88 to 20-98).
9. Apply the appropriate tax treatment for Canadian residents of foreign source employment income, business income and capital gains (P 20-99 to 20-107).
10. Describe the basic concepts behind the taxation of foreign source dividends received by resident individuals (P 20-108 to 20-120).

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11. Describe the taxation of dividends received by resident corporations from non-affiliated corporations (P 20-121).
12. Identify foreign affiliates (P 20-122 to 20-125).
13. Describe the tax treatment of dividends received from non-controlled foreign affiliates, including identification of their various types of surplus balances (P 20-126 to 20-139).
14. Explain the concept of a controlled foreign affiliate (P 20-140 to 20-143).
15. Apply the rules associated with, and the appropriate tax treatment of, foreign property accrual income (FAPI) (P 20-144 to 20-151).
16. Describe the tax treatment of dividends paid from FAPI (P 20-152 to 20-153).

# CHAPTER 21

## How To Work Through Chapter 21

We recommend the following approach in dealing with the material in this chapter:

**Introduction To The GST/HST**

- Read paragraph 21-1 to 21-7 (in the textbook).

**The Current Situation And How We Will Deal With The Complexity**

- Read paragraph 21-8 to 21-16.

**Transaction Tax Concepts, Including VATs**

- Read paragraph 21-17 to 21-41.
- Do Exercise Twenty-One-1 (in the textbook) and check the solution in this Study Guide.
- Do Self Study Problem Twenty-One-1 which is available on MyLab and check the solution in this Study Guide.

**Liability For GST/HST And The Concept Of Supply**

- Read paragraph 21-42 to 21-46.

**Supply Categories (Fully Taxable, Zero-Rated And Exempt)**

- Read from the Note before paragraph 21-47 to 21-60.

**Applying the GST/HST Rate Using the Place Of Supply Rules**

- Read paragraph 21-61 to 21-69.

**Responsibility For Collection And Remittance Of GST/HST**

- Read paragraph 21-70 to 21-73.

**Registration - Including The Small Supplier Exemption**

- Read paragraph 21-74 to 21-88.
- Do Exercise Twenty-One-2 and check the solution in this Study Guide.
- Read paragraph 21-89 to 21-92.
- Do Self Study Problem Twenty-One-2 and check the solution in this Study Guide.

**Input Tax Credits**

- Read paragraph 21-93 to 21-112.
- Do Exercises Twenty-One-3 to Twenty-One-5 and check the solutions in this Study Guide.
- Do Self Study Problems Twenty-One-3 and Twenty-One-4 and check the solutions in this Study Guide.

### Relief For Small Businesses (Quick Method And Simplified ITC Method)

- Read paragraph 21-113 to 21-124.
- Do Exercises Twenty-One-6 and Twenty-One-7 and check the solutions in this Study Guide.
- Do Self Study Problems Twenty-One-5 and Twenty-One-6 and check the solutions in this Study Guide.
- Read paragraph 21-125 to 21-130.
- Do Exercise Twenty-One-8 and check the solution in this Study Guide.

### GST/HST Procedures And Administration, Including GST/HST Returns And Payments

- Read paragraph 21-131 to 21-157.

### Employee And Partner GST/HST Rebate

- Read paragraph 21-158 to 21-166.
- Do Self Study Problem Twenty-One-7 and check the solution in this Study Guide.

### Residential Property And New Housing Rebate

- Read paragraph 21-167 to 21-173.
- Do Self Study Problems Twenty-One-8 and Twenty-One-9 and check the solutions in this Study Guide.

### Sale Of A Business

- Read paragraph 21-174 to 21-187.

### Specific Applications Including Charities, Not-For-Profits And MUSH

- Read paragraph 21-188 and 21-189.

### Partnerships And GST/HST

- Read paragraph 21-190 to 21-198.

### Trusts And GST/HST

- Read paragraph 21-199 to 21-201.

### To Complete This Chapter

- If you would like more practice in problem solving, do the Supplementary Self Study Problems for the chapter. These problems and solutions are available on MyLab.
- Review the Key Terms Used In This Chapter in the textbook at the end of Chapter 21. Consult the Glossary for the meaning of any key terms you do not know.
- Test yourself with the Chapter 21 Glossary Flashcards available on MyLab.
- Ensure you have achieved the Chapter 21 Learning Objectives listed in this Study Guide.
- As a review, we recommend you view the PowerPoint presentation for Chapter 21 that is on MyLab.

### Practice Examination

- Write the Practice Examination for Chapter 21 that is on MyLab. Mark your examination using the Practice Examination Solution that is on MyLab.

## Solutions to Chapter Twenty-One Exercises

### *Exercise Twenty-One - 1 Solution*

**Account-Based System** Under an account-based system, the 5 percent would be applied to the value added, resulting in a tax of $7,600 [(5%)($416,000 - $264,000)].

**Invoice-Credit System** Alternatively, under an invoice-credit system, $20,800 [(5%)($416,000)] would be owing on sales, but would be offset by an input tax credit of $11,650 [(5%)($233,000)] on purchases. The net tax owing in this case would be $9,150, $1,550 larger than the $7,600 tax using the account based system. Note that this $1,550 is equal to 5 percent of $31,000, the difference between the $233,000 in purchases and the $264,000 cost of the merchandise sold.

### *Exercise Twenty-One - 2 Solution*

As Ms. Salome's sales **exceed** $30,000 in the October to December, 2019 quarter, she will be required to begin collecting GST on the first sale in that quarter that causes her to exceed the $30,000 threshold. This means she will have to begin collecting GST sometime between October 1 and December 31. She will be required to register within 29 days of that date.

As Mr. Laughton's sales **accumulate** to more than $30,000 ($8,000 + $13,000 + $4,000 + $17,000 = $42,000) by the end of the January to March, 2020 quarter, he is required to start collecting GST on the first sale on or after May 1, 2020, one month after the quarter in which the $30,000 threshold is reached. Registration is required within 29 days of the first sale on which GST is collected.

### *Exercise Twenty-One - 3 Solution*

The HST payable would be calculated as follows:

| | |
|---|---|
| HST On Sales [(13%)($1,223,000)] | $158,990 |
| Input Tax Credits: | |
| Purchases [(13%)($843,000 + $126,000)] | ( 125,970) |
| Salaries | Nil |
| Interest | Nil |
| Amortization | Nil |
| HST Payable For The Quarter | $ 33,020 |

### *Exercise Twenty-One - 4 Solution*

The HST payable would be calculated as follows:

| | |
|---|---|
| HST On Sales [(15%)($224,000)] | $33,600 |
| Input Tax Credits: | |
| Rent [(15%)($25,800)] | ( 3,870) |
| Assistant's Salary | Nil |
| Capital Expenditures [(15%)($36,000 + $20,000)] | ( 8,400) |
| HST Payable For The Year | $ 21,330 |

### *Exercise Twenty-One - 5 Solution*

The pro rata input tax credit for the land and building acquisition would be $24,000 [(5%)(40%)($1,200,000)]. There would be no input tax credit for the office equipment as it is used less than 50 percent for taxable supplies.

### *Exercise Twenty-One - 6 Solution*

The purchases made do not affect the Quick Method calculation since they are non-capital. The GST payable under the Quick Method would be calculated as follows:

| | |
|---|---|
| Basic Tax [(1.8%)(105%)($42,500)] | $803.25 |
| Credit On First $30,000 [(1%)($30,000)] | ( 300.00) |
| GST Payable For The Quarter | $503.25 |

### *Exercise Twenty-One - 7 Solution*

If the Quick Method is not used, the HST payable (refund) would be calculated as follows:

| | |
|---|---|
| HST On Sales [(13%)($56,100)] | $7,293.00 |
| Input Tax Credits: | |
| Current Expenditures [(13%)($23,400)] | ( 3,042.00) |
| Capital Expenditures [(13%)($42,000)] | ( 5,460.00) |
| HST Payable (Refund) For The Quarter - Regular Method | ($1,209.00) |

Alternatively, under the Quick Method, the calculation would be as follows:

| | |
|---|---|
| Basic Tax [(4.4%)(113%)($56,100)] | $2,789.29 |
| Credit On First $30,000 [(1%)($30,000)] | ( 300.00) |
| Subtotal | $2,489.29 |
| Input Tax Credits: | |
| Current Expenditures | Nil |
| Capital Expenditures [(13%)($42,000)] | ( 5,460.00) |
| HST Payable (Refund) For The Quarter - Quick Method | ($2,970.71) |

As the Quick Method produces a larger refund, it would be the preferable method. Note that input tax credits on capital expenditures are available, even when the Quick Method is used.

### *Exercise Twenty-One - 8 Solution*

To apply the simplified method, we need to know the tax inclusive amounts of current expenditures (given in the problem), as well as the tax inclusive amounts of capital personal property expenditures. This latter figure is $52,500 [(105%)($50,000)]. Using the simplified method, the GST payable (refund) would be calculated as follows:

| | |
|---|---|
| GST Sales [(5%)($315,000 ÷ 1.05)] | $15,000 |
| Input Tax Credits On Purchases And Capital Personal Property [(5/105)($189,000 + $52,500)] | ( 11,500) |
| Input Tax Credits On Capital Real Property [(5%)($150,000)] | ( 7,500) |
| GST Payable (Refund) For The Year | ($ 4,000) |

## Self Study Solution Twenty-One - 1

### *GST Calculation*

Under the normal GST system, a 5 percent tax is applied on the selling price at each stage and the business gets an input tax credit for the tax paid on purchased inputs. The net result is that all payments of GST by vendors are refunded as input tax credits, so there is no net out-of-pocket cost (other than administration) to vendors from the GST.

| Vendor | Cost | Selling Price | GST Charged | ITC Claimed |
|---|---|---|---|---|
| Raw Materials Supplier | | $ 100 | $ 5.00 | Nil |
| Manufacturer | $100 | 150 | 7.50 | $ 5.00 |
| Wholesaler | 150 | 225 | 11.25 | 7.50 |
| Distributor | 225 | 338 | 16.90 | 11.25 |
| Retailer | 338 | 507 | 25.35 | 16.90 |
| Totals | | $1,320 | $66.00 | $40.65 |

The net GST charged for all stages is $25.35 ($66.00 - $40.65). The consumer bears the full cost of the tax by paying GST of $25.35 [(5%)($507)] with no opportunity to get an input tax credit.

### *Turnover Tax Calculation*

The turnover tax is similar to the GST, as it applies to revenue. However, the turnover tax is significantly different as there is no input tax credit for tax paid at each stage on purchased goods (inputs). The tax is passed on to the purchasers in the chain, resulting in pyramiding of the tax. Because of the multiple times goods get taxed, to raise the same amount of tax revenue, the turnover tax rate of 1.92 percent (as shown in the following calculation) is much lower than the 5 percent GST rate.

[($100)(X%)] + [($150)(X%)] + [($225)(X%)] + [($338)(X%)] + [($507)(X%)] = $25.35
[($100 + $150 + $225 + $338 + $507)(X%)] = $25.35
[($1,320)(X%)] = $25.35
X% = $25.35 ÷ $1,320
X% = 1.92%

As verification, the total of the selling price in the above table is $1,320. If the rate of 1.92 percent is applied to this total (the equivalent of each stage charging a turnover tax), the total tax collected would be equivalent to $25.34 (rounding error of $0.01).

## Self Study Solution Twenty-One - 2

### *Calendar Quarter Test*

As taxable sales did not exceed $30,000 in any of the quarters under consideration, the application of this test would not result in Name-Your-Income being required to register.

### *Last Four Calendar Quarters Test (Cumulative)*

Application of this test requires the following analysis of the cumulative last four quarters results:

| Period | Taxable Sales | Net Increase Or Decrease | Cumulative Last Four Quarters |
|---|---|---|---|
| First Quarter 2018 | $ 8,500 | $ 8,500 | $ 8,500 |
| Second Quarter | 6,200 | 6,200 | 14,700 |
| Third Quarter | 7,400 | 7,400 | 22,100 |
| Fourth Quarter | 7,600 | 7,600 | 29,700 |
| First Quarter 2019 | 8,400 | (-8,500+8,400) | 29,600 |
| Second Quarter | 9,200 | (-6,200+9,200) | 32,600 |

The small supplier threshold of $30,000 was exceeded in the second quarter of 2019 (April to June). As a result, Name-Your-Income will have to begin collecting GST on the first sale in the second month following the end of the quarter in which the $30,000 threshold was exceeded. This means that it will have to collect GST on the first sale in August, 2019.

Registration is required within 29 days of the first sale in August, the day GST collection is required to begin.

## Self Study Solution Twenty-One - 3

The HST refund for Norton's Variety for the current period would be calculated as follows:

| | |
|---|---|
| HST Collected [(13%)($250,000)] | $32,500 |
| Input Tax Credits - Current Expenditures: | |
| Purchases Of Fully Taxable Goods | |
| [(13%)($175,000 + $10,000)] | ( 24,050) |
| Purchases Of Zero-Rated Goods (Note 1) | Nil |
| Amortization Expense (Note 2) | Nil |
| Salaries And Wages (Note 3) | Nil |
| Interest Expense (Note 3) | Nil |
| Other Operating Expenses [(13%)(100%)($10,000)] (Note 4) | ( 1,300) |
| Input Tax Credits - Capital Expenditures: | |
| Building [(13%)(40%)($480,000)] (Note 5) | ( 24,960) |
| Equipment (Note 6) | Nil |
| HST Payable (Refund) | ($17,810) |

**Note 1** HST is not paid on purchases of zero-rated goods. As a consequence, there are no input tax credits to be claimed on these purchases.

**Note 2** Amortization expense does not affect the HST calculation.

**Note 3** No HST is paid on salaries and wages, or interest. As a result, no input tax credits are available.

**Note 4** As more than 90 percent of the Other Expenses related to the provision of taxable supplies, the company is eligible for a 100 percent input tax credit.

**Note 5** Input tax credits on real property are available based on a pro rata portion of their usage in providing taxable supplies.

**Note 6** No input tax credits are available on capital expenditures other than real property if less than 50 percent of their usage is to provide fully taxable and zero-rated supplies.

## Self Study Solution Twenty-One - 4

For Part A and Part B, the HST refund for the year would be calculated as follows:

| | Part A | Part B |
|---|---|---|
| HST Collected [(13%)($1,955,000)] | $254,150 | $254,150 |
| Input Tax Credits: | | |
| Purchases [(13%)($1,356,000 - $212,000)] | ( 148,720) | ( 148,720) |
| Amortization Expense | Nil | Nil |
| Salaries And Wages | Nil | Nil |
| Interest Expense | Nil | Nil |
| Other Expenses [(13%)($162,000 - $5,000)] | ( 20,410) | ( 20,410) |
| Equipment [(13%)($725,000)] | ( 94,250) | Nil |
| Building [(13%)(($1,450,000)] | ( 188,500) | |
| [(13%)(73%)($1,450,000)] | | ( 137,605) |
| HST Payable (Refund) | ($197,730) | ($ 52,585) |

In both Part A and Part B, no input tax credit is allowed for HST paid on membership fees or dues in any club whose main purpose is to provide dining, recreational, or sporting facilities.

In Part A, input tax credits are available on both the equipment and the building because 100 percent of their usage is for taxable supplies (fully taxable and zero-rated).

In Part B, there is no input tax credit available on the equipment as it is used less than 50 percent to provide taxable supplies. The building's input tax credit is limited to 73 percent of the HST paid.

## Self Study Solution Twenty-One - 5

The following recommendations are based solely on the minimization of the GST payment. No consideration is given to the reduction in accounting costs available through the use of the Quick Method.

***Claire - Service Business***

The Quick Method would be preferable in this case.

**Regular Method**

| | |
|---|---|
| [($150,000 - $35,000) ÷ 1.05][5%] | $5,476 |

**Quick Method**

| | |
|---|---|
| Basic Tax [($150,000)(3.6%)] | $5,400 |
| Credit On First $30,000 [(1%)($30,000)] | ( 300) |
| Net GST | $5,100 |

***Barbara - Retailer***

The Regular Method is preferable in this case.

**Regular Method**

| | |
|---|---|
| [($150,000 - $100,000) ÷ 1.05][5%] | $2,381 |

**Quick Method**

| | |
|---|---|
| Basic Tax [($150,000)(1.8%)] | $2,700 |
| Credit On First $30,000 [(1%)($30,000)] | ( 300) |
| Net GST | $2,400 |

***Nicole - Service Business***

The Quick Method would be preferable in this case.

**Regular Method**

| | |
|---|---|
| [($120,000 - $35,000) ÷ 1.05][5%] | $4,048 |

**Quick Method**

| | |
|---|---|
| Basic Tax [($120,000)(3.6%)] | $4,320 |
| Credit On First $30,000 [(1%)($30,000)] | ( 300) |
| Net GST | $4,020 |

***Elizabeth - Retailer***

The Quick Method would be preferable in this case.

**Regular Method**

| | |
|---|---|
| [($120,000 - $75,000) ÷ 1.05][5%] | $2,143 |

**Quick Method**

| | |
|---|---|
| Basic Tax [($120,000)(1.8%)] | $2,160 |
| Credit On First $30,000 [(1%)($30,000)] | ( 300) |
| Net GST | $1,860 |

## Self Study Solution Twenty-One - 6

### *Part A*

Using the regular calculations, the HST payable for Larkin Ltd. for the current year would be calculated as follows:

| | |
|---|---|
| HST Collected [(13%)($103,000)] | $13,390 |
| Input Tax Credits On Current Expenditures: | |
| Purchases [(13%)($63,000 + $6,000)] | ( 8,970) |
| Amortization Expense | Nil |
| Salaries And Wages | Nil |
| Rent [(13%)($24,000)] | ( 3,120) |
| Interest Expense | Nil |
| Other Operating Expenses [(13%)($12,000)] | ( 1,560) |
| Input Tax Credits On Capital Expenditures [(13%)(100%)($36,160 ÷ 1.13)] | ( 4,160) |
| HST Payable | ($ 4,420) |

**Notes:**

- Amortization expense does not affect the HST calculation.
- No HST is paid on salaries and wages, or interest. As a result no input tax credits are available.
- Full input tax credits are available on capital expenditures other than real property if more than 50 percent of their usage is to provide fully taxable supplies.

### *Part B*

As Larkin's HST included taxable sales of $116,390 [(113%)($103,000)] is less than $400,000 and it is not engaged in an ineligible business such as accounting, Larkin can use the Quick Method.

### *Part C*

The Quick Method calculations would be as follows:

| | |
|---|---|
| Basic Tax [(4.4%)(113%)($103,000)] | $5,121 |
| Credit On First $30,000 [(1%)($30,000)] | ( 300) |
| Total Before Capital Expenditures | $4,821 |
| Input Tax Credit On Capital Expenditures [(13%) (100%)($36,160 ÷ 1.13)] | ( 4,160) |
| HST Payable | $ 661 |

In this case, the regular HST calculations are preferable as it produces a refund rather than requiring a remittance.

## Self Study Solution Twenty-One - 7

The maximum CCA that George can claim is as follows:

| | |
|---|---|
| Opening UCC ($27,750 - $4,163) | $23,587 |
| GST Rebate Claimed On Car CCA In Preceding Year | ( 198) |
| Adjusted UCC | $23,389 |
| Class 10 Rate | 30% |
| Maximum CCA | $ 7,017 |

The employee GST rebate for George would be calculated as follows:

| | | |
|---|---|---|
| Total Expenses Other Than CCA | $28,000 | |
| GST Exempt Purchases: | | |
| Interest | ( 2,600) | |
| Insurance | ( 1,200) | |
| Eligible Expenses Other Than CCA | $24,200 | |
| Rate | 5/105 | $1,152 |
| Eligible CCA | $7,017 | |
| Rate | 5/105 | 334 |
| Employee GST Rebate | | $1,486 |

## Self Study Solution Twenty-One - 8

The calculation of the new housing GST rebate is as follows:

**[A][($450,000 - B) ÷ $100,000],** where

**A** = The lesser of 36 percent of the GST paid and $6,300; and
**B** = The greater of $350,000 and the cost of the home.

The GST and total cost of each purchase would be as follows.

### *Property A*

As the renovations involve more than 90 percent of the interior, they will be considered substantial. Since the renovations would be done by the vendor prior to the sale, the purchase would be deemed to be that of a "new" home. As a result, the total purchase price would be subject to GST and a new housing rebate could be claimed on the total, as follows:

| | |
|---|---|
| GST Payable [($370,000)(5%)] | $ 18,500 |
| Less New Housing Rebate, where | |
| A = the lesser of [(36%)($18,500)] = $6,660 and $6,300 | |
| B = the greater of $350,000 and $370,000 | |
| [$6,300][($450,000 - $370,000) ÷ $100,000] | ( 5,040) |
| Net GST Payable | $ 13,460 |
| Purchase Price | 370,000 |
| Total Cost | $383,460 |

### *Property B*

As this property is a used residential unit, no GST will be payable. This means that the total cost will be $387,000.

***Property C***

GST will be paid on the purchase price of $323,000, plus all of the improvements. However, the new housing rebate is only available on the $10,000 cost of the improvements done by the builder in addition to the purchase price. It is not available on the additional $12,000 of costs incurred by Martin.

| | |
|---|---|
| GST Payable [($323,000 + $10,000 + $12,000)(5%)] | $ 17,250 |
| Less New Housing Rebate, where | |
| A = the lesser of [(36%)(5%)($323,000 + $10,000)] = $5,994 and $6,300 | |
| B = the greater of $350,000 and $345,000 | |
| [$5,994][($450,000 - $350,000) ÷ $100,000] | ( 5,994) |
| Net GST Payable | $ 11,256 |
| Purchase Price ($323,000 + $10,000 + $12,000) | 345,000 |
| Total Cost | $356,256 |

## Self Study Solution Twenty-One - 9

***GST Consequences***

As used residential properties are not subject to GST, the renovator would not have paid any tax on the $85,000 purchase.

With respect to the sale, the GST treatment will depend on whether the upgrading was a substantial or non-substantial renovation. Given that 100 percent of the interior was replaced, it would be considered a substantial renovation. As a result, the sale would be treated as a taxable supply of a new home and would be subject to GST. This, in turn, means that GST paid on the costs of renovations can be claimed as input tax credits.

These credits can be claimed when the expenses are incurred, without regard to when the house is sold. The renovator could also claim input tax credits on GST that would be paid on commissions and transfer fees.

***Cost Of House And Net Profit***

For the purchaser, the usual 5 percent rate applied to the sales price of $200,000 would result in a basic GST figure of $10,000. However, as the house has a purchase price below $350,000, the purchaser would be eligible for a rebate equal to 36 percent of the GST paid. This rebate would be $3,600 [(36%)($10,000)], leaving a net GST payable of $6,400 ($10,000 - $3,600). The net cost of the house to the purchaser would then be $206,400.

The net profit on the transaction for the renovator, calculated net of GST payment and input tax credits, would be calculated as follows:

| | | |
|---|---|---|
| Selling Price | | $200,000 |
| Less Costs: | | |
| Purchase Price | ($85,000) | |
| Subcontractors - No GST Included | ( 10,700) | |
| Subcontractors (Net Of $1,000 GST) | ( 20,000) | |
| Materials (Net Of $1,500 GST) | ( 30,000) | |
| Employee Wages - No GST Included | ( 6,000) | ( 151,700 |
| Net Profit | | $ 48,300 |

***GST Remittance***

The contractor will have a liability for GST as follows:

| | | |
|---|---|---|
| GST Charged (Net Of Rebate) | | $ 6,400 |
| Less Input Tax Credits: | | |
| Subcontractors [($21,000 ÷ 105%)(5%)] | ($1,000) | |
| Materials [($31,500 ÷ 105%)(5%)] | ( 1,500) | ( 2,500) |
| GST Remittance | | $ 3,900 |

This solution assumes the purchaser assigns the rebate to the builder on closing. If this is not the case, the purchaser would apply personally for the $3,600 GST rebate, and the renovator's GST remittance would be $3,600 larger.

## Chapter 21 Learning Objectives

After completing Chapter 21, you should be able to:

1. Describe, in general terms, the current transaction tax situation (GST/HST) in all of the provinces (paragraph [P hereafter] 21-1 to 21-16).
2. Describe the different ways in which transaction taxes can be assessed and the approach the GST/HST uses (P 21-17 to 21-41).
3. Explain the basic charging provision for GST/HST and the concept of supply (P 21-42 to 21-46).
4. Outline the difference between fully taxable supplies, zero-rated supplies, and exempt supplies (P 21-47 to 21-60).
5. Explain the place of supply rules and how the GST/HST is applied to tangible goods, real property and services (P 21-61 to 21-69).

6. Explain who is responsible for collecting and remitting the GST/HST (P 21-70 to 21-73).
7. Determine whether an entity is required to register for GST and if so, at what point in time registration is required (P 21-74 to 21-92).
8. Apply the rules for calculating input tax credits on current and capital expenditures (P 21-93 to 21-99).
9. Explain some of the basic restrictions on claiming input tax credits (P 21-100 to 21-102).
10. Discuss input tax credits as they relate to vendors of exempt supplies (P 21-103).

11. Describe the relationship between amounts determined for accounting, income tax and GST/HST purposes (P 21-104 to 21-108).
12. Calculate the GST/HST payable or refund when fully taxable, zero-rated and exempt supplies are provided (P 21-109 to 21-112).
13. Apply the quick method of accounting for GST/HST (P 21-113 to 21-124).
14. Apply the simplified method of accounting for input tax credits (P 21-125 to 21-130).
15. Outline the basic procedures and administration of the GST/HST (P 21-131 to 21-157).

16. Calculate the employee and partner GST/HST rebate (P 21-158 to 21-166).
17. Calculate the effects of GST/HST on the acquisition and disposition of residential property, including new homes (P 21-167 to 21-173).
18. Describe the possible GST/HST implications resulting from the sale of a business (P 21-174 to 21-187).
19. Briefly describe how the GST/HST applies to certain types of organizations such as those included in MUSH (P 21-188 and 21-189).
20. Describe the GST/HST implications related to partner expenses, dispositions of partnership interests, transfers between a partnership and its partners and the reorganization of partnerships (P 21-190 to 21-198).
21. Explain the applicability of GST/HST legislation to trusts (P 21-199 to 21-201).

# GLOSSARY

## A

**Accelerated Investment Incentive (AccII)** A temporary program that encourages investments in capital assets by providing an accelerated CCA deduction on net acquisitions during the year of acquisition.

**Accrual Basis** A method of accounting for Income based on recording assets when the right to receive them is established and liabilities when the obligation to pay them arises.

**Acquisition Of Control** Acquisition of sufficient voting shares of a corporation, by a Person, or Group Of Persons, that they have the right to elect a majority of the board of directors of the Corporation.

**Active Business** A business carried on by a Taxpayer, other than a Specified Investment Business or a Personal Services Business.

**Active Business Income** Income earned by an Active Business.

**Additional Refundable Tax On Investment Income (ART)** A 10-2/3% tax on the Aggregate Investment Income of a CCPC.

**Adjusted Active Business Income** A term used in calculating the M&P Deduction, defined as the excess of a Corporation's Income from Active Business, less a Corporation's losses from Active Business. It does not appear to be a different concept than Active Business Income of a Corporation.

**ADJUSTED Aggregate Investment Income** A modified version of Aggregate Investment Income that is used to calculate a possible grind of the annual business limit for the small business deduction.

**Adjusted Cost Base** For depreciable capital property it is the cost of the property to the Taxpayer. For non-depreciable capital property it is the cost of the property to the Taxpayer, subject to ITA 53 adjustments (e.g., deduction of government grants on land purchase).

**Adjusted Taxable Income** Regular Taxable Income, adjusted to remove certain tax preferences. Used to calculate the Alternative Minimum Tax.

**Adoption Expenses Tax Credit** A credit against Tax Payable that is available to individuals with eligible adoption expenses.

**Advance Tax Ruling** Interpretations provided, at the request of a taxpayer, by the Income Tax Rulings Directorate as to how a particular transaction will be treated for tax purposes. Such interpretations are not binding on the CRA.

**Affiliated Group Of Persons** A Group Of Persons each member of which is affiliated with every other member.

**Affiliated Person [ITA 251.1(1)]** For an Individual, an Affiliated Person is that individual's Spouse or Common-Law Partner. For a Corporation, an Affiliated Person is a Person or an Affiliated Group Of Persons who Controls the Corporation, or the Spouse or Common-Law Partner of either the Person who Controls, or a member of the group that Controls. More complex rules apply to determine affiliation between two Corporations.

**Age Tax Credit** A credit against Tax Payable that is available to Individuals who are 65 years of age or older.

**Aggregate Investment Income** As defined in ITA 129(4), this concept of investment income includes net Taxable Capital Gains for the year reduced by any Net Capital Loss carry overs deducted in the year, Interest Income, rents, and royalties.

**Alimony** A term that was used at an earlier point in time to refer to both Spousal Support and Child Support.

**Allowable Business Investment Loss** The deductible portion (currently one-half) of a Business Investment Loss.

**Allowable Capital Loss** The deductible portion (currently one-half) of a Capital Loss.

**Allowance** An amount paid by an employer to an Employee to provide for certain types of costs incurred by the Employee, usually travel costs or automobile costs.

**Alter Ego Trust** An Inter Vivos Trust established by an Individual aged 65 years or more, subject to the conditions that the Individual must be entitled to all of the Trust's Income during his/her lifetime, and the Individual must be the only Person who can access the capital of the Trust during his/her lifetime.

**Alternative Minimum Tax (AMT)** A tax, calculated at the minimum federal rate on Adjusted Taxable Income, less a basic $40,000 exemption.

**Amalgamation** A Rollover provision which allows two Taxable Canadian Corporations to be combined into a single Taxable Canadian Corporation, without tax consequences.

**Annual Business Limit** The maximum amount of Active Business Income that is eligible for the Small Business Deduction in a particular taxation year (currently $500,000).

**Annual Child Care Expense Amount** The annual per child limit for deductible Child Care Expense. The amount is $5,000, $8,000, or $11,000, depending on the age and health of the child.

**Annual Gains Limit** Taxable Capital Gains for the current year on qualified assets, less the sum of Allowable Capital Losses and Net Capital Loss Carry Overs deducted during the current year, plus Allowable Business Investment Losses realized during the current year. Used to determine the Lifetime Capital Gains Deduction for the current year.

**Annuitant** This term is used to describe a Person who is receiving an Annuity. However, in tax publications this term is often (and incorrectly) used to refer to the Beneficiary of an RRSP or RPP.

**Annuity** A series of periodic payments that continues for a specified period of time, or until the occurrence of some event (e.g., the death of the Annuitant).

**Anti-Avoidance Provision** A provision in the *Income Tax Act* that is designed to prevent a Taxpayer from taking some action that would allow him to avoid taxes.

**Apprenticeship Job Creation Tax Credit** An Investment Tax Credit that is available to eligible employers (individuals and corporations) for salaries and wages paid to qualifying apprentices.

**Arm's Length** ITA 251(1) indicates that Related Persons (see definition) do not deal with each other at arm's length. Also, a taxpayer and a personal trust do not deal with each other at arm's length. In other cases, it is a question of fact as to whether an arm's length relation exists.

**ART** An acronym for "additional refundable tax on investment income".

**Assessment** A formal determination of taxes to be paid or refunded. A Reassessment is a form of Assessment.

**Associated Corporations** Two or more Corporations that have an ownership/control arrangement that falls into one of the categories described in ITA 256(1) (e.g., two Corporations controlled by the same Person).

**At-Risk Amount** A defined measure that limits the amount of deductions that can be flowed through to a Limited Partner.

**At-Risk Rules** A set of rules, directed largely at Limited Partners, designed to prevent an investment from creating tax deductions that exceed the amount invested (the At-Risk Amount).

## B

**Basic Federal Tax Payable** An amount of individual Tax Payable that has been reduced by some, but not all of the Tax Credits available to individuals. Used in the calculation of Tax Payable of Canadian Residents who do not live in a province.

**Beneficiary** The Person who will receive the benefits from a Trust.

**Billed Basis** A method of determining Net Business Income based on recording inclusions when the relevant amounts are billed. Can only be used by certain specified types of professionals (e.g., accountants).

**Bonus Arrangement** As used in this material, a tax planning arrangement for Employees. A Corporation declares and deducts a bonus near the end of its fiscal year. It is usually designed to be paid to the Employee early in the following calendar year. As Employment Income is taxed on a Cash Basis, the bonus will not be taxed in the employee's hands until that year.

**Bonusing Down** A process of paying deductible salary to the owner-manager of a CCPC, or related parties, in order to eliminate corporate Taxable Income that is not eligible for the Small Business Deduction.

**Boot** A colloquial term used by tax practitioners to refer to Non-Share Consideration.

**Business** A business is a self-sustaining integrated set of activities and assets conducted and managed for the purpose of providing a return to investors. A business consists of (a) inputs, (b) processes applied to those inputs, and (c) resulting outputs that are used to generate revenues.

**Business Combination** A transaction in which an enterprise acquires net assets that constitute a business, or acquires an equity interest in a Corporation that gives the enterprise Control over the operating, financing, and investing decisions of that Corporation.

**Business Income** Income that is earned through Active Business activity. This would include amounts earned by producing goods, selling goods or services, or delivering services. While usage is not always consistent, this term usually refers to a net amount (i.e., inclusions less deductions, or revenues less expenses).

**Business Investment Loss** A loss resulting from the Disposition of shares or debt of a Small Business Corporation.

## C

**Canada Caregiver Amount For Child** A credit against tax payable that is available to an individual who provides care and/or support for a child under 18 years of age who has a mental or physical infirmity.

**Canada Caregiver Tax Credit** A credit against tax payable that is available to an individual who provides care and/or support for certain specified dependants who have a mental or physical infirmity.

**Canada Child Benefit** A monthly payment that is available to Individuals with children. The non-taxable payments may be reduced or eliminated if Income is in excess of a threshold amount.

**Canada Disability Savings Bonds** A system of grants under which the federal government makes contributions to an Individual's RDSP based on family net income.

**Canada Disability Savings Grants** A system of grants under which the federal government makes contributions to an Individual's RDSP based on a percentage of the contributions to that Individual's RDSP that have been made by others.

**Canada Education Savings Grants** A system of grants under which the federal government makes contributions to an Individual's RESP based on a percentage of the contributions to that Individual's RESP that have been made by others.

**Canada Employment Credit** A credit against Tax Payable that is available to individuals with employment income.

**Canada Learning Bonds** A system of grants under which the federal government makes contributions to an Individual's RESP based on the number of years in which the Individual's family is eligible for the National Child Benefit supplement.

**Canada Pension Plan (CPP)** A pension plan sponsored by the federal government. Individuals with Employment or Business Income must make contributions based on their income and, in return, receive benefits in future years.

**Canada Pension Plan Tax Credit** A credit against Tax Payable that is available to Individuals making contributions to the Canada Pension Plan.

**Canada Training Credit** A refundable credit that provides a refund to eligible individuals for a portion of training related costs.

**Canada Workers Benefit** A refundable credit available to low income individuals who are earning employment and business income (formerly Working Income Tax Benefit).

**Canadian Controlled Private Corporation** A Corporation that is controlled by Persons Resident in Canada and that does not have any of its shares listed on a designated stock exchange.

**Canadian Corporation** A Corporation that is resident in Canada.

**Canadian Partnership** A Partnership, all of the members of which are Residents of Canada at the time the term is relevant.

**Capital Asset** An asset that is held for the purpose of producing Income.

**Capital Cost** The amount paid to acquire a depreciable asset. The tax equivalent of acquisition cost in accounting.

**Capital Cost Allowance (CCA)** A deduction in the determination of Business or Property Income based on the capital cost of capital assets. The tax equivalent of accounting amortization.

**Capital Dividend** A Dividend paid out of a Private Corporation's Capital Dividend Account. It is received on a tax free basis.

**Capital Dividend Account** An account that tracks a group of items, defined in ITA 89(1), that can be distributed by Private Corporations to shareholders as a tax free Capital Dividend (e.g., the non-taxable portion of realized Capital Gains).

**Capital Gain** The excess of proceeds resulting from the Disposition of a capital asset, over the sum of the Adjusted Cost Base of the asset plus any costs of disposition.

**Capital Gains Reserve** A Reserve that is deductible against Capital Gains. It is available when some part of the Proceeds Of Disposition is not collected in the period of disposition.

**Capital Gains Stripping** Procedures designed to allow a Corporation to convert a taxable capital gain resulting from the Disposition of investment shares to an arm's length party, into a tax free intercorporate Dividend.

**Capital Interest (In A Trust)** All rights of the Taxpayer as a Beneficiary under the trust, other than those that are an Income Interest in the Trust.

**Capital Loss** The excess of the sum of the Adjusted Cost Base of a capital asset plus any costs of disposition, over the proceeds resulting from the Disposition of the asset.

**Capital Personal Property** For GST purposes, any capital property other than Real Property.

**Capital Tax** A tax assessed on the capital of a Corporation, without regard to its Income.

**Carry Over** As used in tax work, the ability to apply current year losses against Income in earlier or later years.

**Cash Basis** A method of accounting for Income based on cash receipts and cash disbursements.

**Cash Damming** Situations in which a separate bank account is established to receive all deposits of borrowed funds. Expenditures from this account are then limited to those which qualify for interest deductibility. This procedure facilitates linking the borrowed money to income producing investments.

**CCPC** An acronym for "Canadian controlled private corporation".

**Charitable Donations Tax Credit** A credit against Tax Payable that is available to Individuals making donations to qualifying charitable organizations.

**Charitable Gifts** Donations to a registered charity, a registered Canadian amateur athletic association, a housing corporation resident in Canada that is exempt from tax under ITA 149(1)(i), a Canadian municipality, the United Nations or an agency thereof, a university outside of Canada which normally enrolls Canadian students, and a charitable organization outside of Canada to which Her Majesty in right of Canada has made a gift in the year or in the immediately preceding year.

**Child Care Expenses** Costs associated with caring for an Eligible Child.

**Child Support** A Support Amount that is not identified as being for the benefit of a Spouse or Common-Law Partner, or a former Spouse or Common-Law Partner.

**Class** As used in tax work, a defined group of depreciable assets for which the *Income Tax Regulations* specify the CCA rate to be applied, as well as the method to be used in applying the rate.

**Clawback** An income tested taxing back, or reduction, in the payment of Old Age Security benefits and Employment Insurance benefits.

**Climate Action Incentive Payments** A refundable credit based on family size that is available to the residents of four provinces and two territories, specifically Manitoba, New Brunswick, Ontario, Saskatchewan, Nunavut and Yukon.

**Commercial Activity** This is a GST term which refers to any business or trade carried on by a Person, or any supply of real property made by a Person. Commercial Activity does not include any activity involved with making an exempt supply or any activity engaged in by an Individual without a Reasonable Expectation Of Profit.

**Commodity Tax** A type of Transaction Tax that is applied to the sale of certain types of commodities (e.g., taxes on the sale of tobacco products).

**Common Shares** Corporate shares that normally have all of the rights which are provided for under the relevant corporate enabling legislation. While there may be variations in the rights of such shares, at a minimum, voting rights would have to be present for the shares to be considered Common Shares.

**Common-Law Partner** A Person who cohabits in a conjugal relationship with the Taxpayer and (a) has so cohabited with the Taxpayer for a continuous period of at least one year, or (b) is a parent of a child of whom the Taxpayer is also a parent.

**Comparable Uncontrolled Price** A Transfer Pricing method that bases transfer prices on the prices used in comparable transactions between arm's length buyers and sellers, operating in the same market and under the same terms and conditions.

**Connected Corporation** Corporation A is connected with Corporation B if Corporation B Controls Corporation A, or if Corporation B owns more than 10% of the voting shares of Corporation A and more than 10% of the fair market value of all issued shares of Corporation A.

**Consent Form** A form that is used when a taxpayer wishes to have a different person represent him in dealing with the CRA. This form (T1013) authorizes the CRA to disclose information to, and deal with, a specified representative.

**Consumption Tax** A tax levied on the consumption of some product or service. This type of tax is also called a sales tax.

**Contributed Capital** In accounting usage, the amount of a Corporation's Shareholders' Equity that was received in return for issuing the shares that are currently outstanding.

**Control [ITA 256(1.2)(c)]** A Corporation, Person or Group Of Persons has Control of a Corporation if that Corporation, Person or Group Of Persons owns either more than 50% of the Common Shares of that Corporation or, alternatively, owns shares (common and/or preferred) with a fair market value that exceeds 50% of the fair market value of all of the outstanding shares of that Corporation.

**Control (IAS 27)** Control is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.

**Controlled [ITA 251.1(3)]** Under ITA 251.1(3), Controlled means controlled, directly or indirectly in any manner whatever. [The reference here is to de facto control, which does not necessarily require majority ownership of shares.]

**Controlled Foreign Affiliate** A Foreign Affiliate of the Taxpayer that was controlled by (a) the Taxpayer, (b) the Taxpayer and not more than four other Persons Resident in Canada, (c) not more than four Persons Resident in Canada, other than the Taxpayer, (d) a Person or Persons with whom the Taxpayer does not deal at arm's length, or (e) the Taxpayer and a Person or Persons with whom the Taxpayer does not deal at arm's length.

**Convertible Property** A debt or equity financial instrument of a Corporation that can be exchanged for an equity financial instrument of the same Corporation, without the payment of additional consideration.

**Co-Ownership** Ownership of a single real or personal property by two or more Persons.

**Corporation** An artificial legal entity created through either federal or provincial legislation.

**Cost Of Capital (M&P)** For purposes of calculating the M&P Deduction, this amount is 10% of the Gross Cost of Capital Assets used by the corporation, plus 100% of rents paid for Capital Assets used by the Corporation.

**Cost Of Labour (M&P)** For purposes of calculating the M&P Deduction, this is the total cost of salaries and wages, plus non-salary amounts paid for employee-like services.

**Crowdfunding** Funding a project, venture or business by raising funds from a large number of people, usually in small amounts and usually via the internet.

**Crown Gifts** Gifts made to Her Majesty in right of Canada or to Her Majesty in right of a province.

**Cultural Gifts** Gifts of objects that the Canadian Cultural Property Export Review Board has determined meet the criteria of the *Cultural Property And Import Act*.

**Cumulative Eligible Capital (CEC)** This term was used to refer to the amortized balance of Eligible Capital Expenditures. No longer available after 2016.

**Cumulative Gains Limit** Taxable Capital Gains on qualified assets that have been realized since 1984, less the sum of Allowable Capital Losses and Net Capital Loss Carry Overs deducted after 1984, plus Allowable Business Investment Losses realized after 1984, capital gains deductions claimed in previous taxation years, and the Cumulative Net Investment Loss at the end of the year. Used to determine the Lifetime Capital Gains Deduction for the current year.

**Cumulative Net Investment Loss (CNIL)** The amount by which the aggregate of investment expenses for the current year and prior years ending after 1987, exceeds the aggregate of investment income for that period.

**Customs Duties** A tax imposed on the importation or exportation of certain goods or services.

## D

**Death Benefit** All amounts in excess of $10,000 that are received by a Taxpayer in a taxation year, on or after the death of an Employee, in recognition of the Employee's service in an office or employment.

**Declining Balance Method** A method of calculating CCA in which a specified rate is applied to the ending UCC balance in a depreciable asset Class in order to determine the CCA for the period.

**Deemed Disposition** A requirement to assume that a Disposition has taken place when, in fact, a disposition transaction has not occurred (e.g., a change in use is deemed to be a Disposition).

**Deemed Dividends** A group of capital transactions and distributions, as specified in ITA 84(1), that are deemed to be Dividend payments.

**Deemed Resident** An Individual who is considered a Resident of Canada because of some factor other than physical presence in Canada (e.g., members of the Canadian armed forces are deemed to be Canadian Residents under ITA 250 without regard to where they are physically located).

**Deemed Year End** A requirement to have a taxation year end at a specified date, or as the result of a specified event.

**Deeming Rules** Rules that are used to require that an item or event be given a treatment for tax purposes that is not consistent with the actual nature of the item or event (e.g., members of the Canadian armed forces are deemed to be Canadian Residents even if they are not present in Canada at any time during the year).

**Deferred Income Plans** A group of plans that allow Individuals to receive Income on a tax deferred basis. These include Registered Pension Plans, Deferred Profit Sharing Plans, Registered Retirement Savings Plans, and Registered Retirement Income Funds.

**Deferred Profit Sharing Plan (DPSP)** A trusteed plan to which employers can make deductible contributions, the amount of which is related to the profits of the enterprise, and which do not create a Taxable Benefit for the recipient employees. Earnings accumulate tax free within the plan. Withdrawals from the plan are subject to tax.

**Defined Benefit Plan** A retirement savings plan in which the plan sponsor (usually an employer) promises a known or determinable retirement benefit and assumes financial responsibility for providing that benefit.

**Defined Contribution Plan (a.k.a., Money Purchase Plan)** A retirement savings plan in which the plan sponsor (employer or individual) makes known or determinable contributions. The retirement benefit is based on the accumulated contributions and earnings on investments within the plan.

**Dependant** As defined in ITA 118(6), an Individual who, at any time during the year, is dependent on the taxpayer for support and is the child or grandchild of the Individual or of the individual's Spouse or Common-Law Partner, the parent, grandparent, brother, sister, uncle, aunt, niece, or nephew, if resident in Canada at any time in the year, of the Individual or of the individual's Spouse or Common-Law Partner.

**Depreciable Capital Property** Capital property, such as equipment or furniture and fixtures, that is subject to depreciation or amortization.

**Designated Stock Exchange** A stock exchange that has been designated as such by the Minister of Finance. Replaces the term "prescribed stock exchange".

**Digital News Subscriptions Credit** A non-refundable tax credit for individuals based on their expenditures for digital subscriptions with a Qualifying Canadian Journalism Organization.

**Disability Supports Deduction** A deduction available to individuals for attendant care and other disability support expenses, incurred to allow the disabled individual to work or to attend a designated educational institution.

**Disability Tax Credit** A credit against Tax Payable that is available to Individuals with a doctor certified severe mental or physical disability. Can be transferred to a supporting Individual.

**Disability Tax Credit Supplement** A supplement to the Disability Tax Credit available to individuals who are under 18 years of age at the end of the year.

**Disappearing Source Rules** Rules designed to provide relief to investors who have borrowed money to make an investment and subsequently sold the investment for less than the related borrowings. These rules provide that any amount of debt that remains after the proceeds of the sale are used to pay off a portion of the total balance is deemed to be debt that is used to produce income.

**Discretionary Trust** A Trust for which the Settlor has given the Trustee discretion to decide the amounts of income or capital to be allocated to each Beneficiary.

**Disposition** The disposal of an asset through sale, gift, physical destruction, conversion, expropriation, or other means.

**Dividend Gross Up** An amount that is based on a percentage of the Dividends from Taxable Canadian Corporations that have been received by an Individual or Trust. This amount must be included in the Net Income For Tax Purposes of the Individual or Trust.

**Dividend Stripping** Procedures designed to allow an Individual to remove accumulated Income from a Corporation in the form of tax-free capital gains, while still retaining Control of the Corporation.

**Dividend Tax Credit** A credit against the Tax Payable of an Individual or Trust. The amount is based on a fraction of the Dividend Gross Up that has been included in Net Income For Tax Purposes.

**Dividends** Amounts declared and paid, at the discretion of management, as a return on equity investments.

**Dividends In Kind** Dividends, other than Stock Dividends, paid in corporate assets other than cash.

**Division B Income** An alternative name for Net Income For Tax Purposes.

**Double Taxation** A reference to situations in which the same stream of Income is subject to tax a second time.

**Dual Resident** A taxpayer who is considered to be a Resident of two countries.

## E

**Earned Capital (a.k.a. Retained Earnings)** In accounting usage, the amount of a Corporation's Shareholders' Equity that resulted from the retention of earnings in the corporation.

**Earned Income (Child Care Expenses)** For purposes of determining the deductible amount of Child Care Expenses, Earned Income is defined as Employment Income (gross), Business Income (not losses), and Income from scholarships, training allowances, and research grants.

**Earned Income (RRSP Deduction Limit)** The sum of Employment Income (without the RPP deduction), Business Income (losses), royalties (if the taxpayer is the author, inventor, or composer), taxable (deductible) support payments, supplementary unemployment benefits, income (loss) as an active partner, net rental income (loss), research grants (net of certain expenses), and CPP disability benefits.

**Earned Surplus** An archaic accounting description of what now is called Retained Earnings. However, the term continues to be found in the *Income Tax Act*.

**Ecological Gifts** Gifts of land certified by the Minister of the Environment to be ecologically sensitive land, the conservation and protection of which is important to the preservation of Canada's environmental heritage.

**Election** A choice that is available to a Taxpayer with respect to a particular tax outcome (e.g., a Taxpayer can elect to have the spousal Rollover provision not be applicable).

**Eligible Capital Expenditure** This term was used to refer to an amount expended to acquire an intangible asset that was not eligible for CCA or deduction. No longer available after 2016.

**Eligible Capital Property** An intangible asset that results from making an Eligible Capital Expenditure.

**Eligible Child** With respect to the deductibility of Child Care Expenses, a child of the Taxpayer, his Spouse, or a child who is dependent on the Taxpayer or his Spouse, and whose Income does not exceed the basic personal tax credit base amount. An Eligible Child must either be under 16 years of age at some time during the year, or dependent on the Taxpayer or his Spouse by reason of physical or mental infirmity.

**Eligible Dependant Tax Credit** A credit against Tax Payable that is available to a single Individual supporting a Dependant in a self-contained domestic establishment.

**Eligible Dividends** Dividends that have been designated by the payor as eligible for the enhanced gross up and tax credit procedure.

**Eligible Newsroom Employee** An individual who is employed by a Qualifying Canadian News Organization and who spends at least 75% of their time engaged in the production of news content, including researching, collecting information, verifying facts, photographing, writing, editing, designing, and otherwise preparing content.

**Eligible RDTOH** A balance containing refundable taxes that are available for dividend refunds on eligible dividends paid.

**Emigration** Leaving a country, usually in order to establish permanent residency in another country.

**Employee** An Individual who has an employment relationship with an entity that provides remuneration. Whether or not an Individual is working as an Employee or a Self-Employed Individual is dependent on factors such as control, ownership of tools, chance of profit or risk of loss, and the ability to subcontract or hire an assistant.

**Employee and Partner GST Rebate** A provision that allows employees and partners to recover the GST paid on their employment or partnership related expenses.

**Employer/ Employee Relationship** A written, verbal, or tacit agreement in which an Employee agrees to work on a full-time or part-time basis for an employer for a specified or indeterminate period of time, in return for Salary or wages. The employer has the right to decide where, when, and how the work will be done. In this type of relationship, a contract of services exists.

**Employment Income** The Salary, wages, and other remuneration, including gratuities, received by an Employee in the year (see Employer/Employee Relationship).

**Employment Insurance (EI)** A federal insurance plan designed to provide benefits to unemployed Individuals. In order to receive benefits, Employees must make contributions when they are employed.

**Employment Insurance Tax Credit** A credit against Tax Payable that is available to Employees making payments to the federal Employment Insurance plan.

**Estate** As the term is used in the *Income Tax Act*, the property of a deceased Individual.

**Estate Freeze** Procedures undertaken by an Individual in order to fix a tax value for all or part of the Individual's property, and to Transfer future growth in the value of this property to other Individuals.

**Estate Planning** Tax planning directed towards the distribution of an Individual's property at death.

**Excessive Eligible Dividend Designation (EEDD)** A balance, subject to Part III.1 tax, which reflects an inappropriate designation of an amount of dividends paid as an Eligible Dividend.

**Exchange Of Shares In A Reorganization (ITA 86)** A Rollover provision that allows one class of shares in a Corporation to be exchanged for a different class of shares, without tax consequences.

**Excluded Business** A business is an Excluded Business of a Specified Individual if that individual is actively engaged in its activities on a regular, continuous and substantial basis, either in the current taxation year or, alternatively, in any 5 prior taxation years.

**Excluded Shares** For shares to be classified as Excluded Shares, the Specified Individual must be aged 25 or older and must own, in terms of both fair market value and voting rights, at least 10 percent of the outstanding shares of the corporation. In addition, the corporation must not be a Professional Corporation, less than 90 percent of its business in the previous taxation year is from services, and less than 10 percent of its income in the previous year is from a related business.

**Executor** A Person appointed by an Individual in their Will to oversee the administration of the Estate on their death in accordance with the terms of that Will.

**Exempt Goods And Services** Goods and services that are not subject to the GST. Registrants who sell Exempt Goods And Services are not eligible for Input Tax Credits for GST paid. Examples include sales of used residential housing, most medical services, and most financial services.

**Exempt Surplus** A surplus account that tracks certain sources of income of a Foreign Affiliate.

## F

**Fairness Package** Replaced by the Taxpayer Relief Provisions.

**Family Trust** An Inter Vivos Trust, established by an Individual, with family members as Beneficiaries.

**Farm Property** Farm Property includes real estate and property that is used in farming activities, a share of a Corporation that is carrying on a farming business, or an interest in a Partnership that is carrying on a farming business.

**Federal Tax Abatement** A 10 percentage point reduction in the federal tax rate on Corporations, applicable to Income earned in a province.

**Final Tax Return** A term used to describe the tax return filed for an Individual for the year of their death.

**First Time Home Buyer's Tax Credit** A credit against Tax Payable equal to 15% of $5,000 of the cost of an individual's first Principal Residence.

**First Year Rules** See Half-Year Rules.

**Fiscal Period** A taxation year that does not exceed 53 weeks.

**Fishing Property** Fishing Property includes real estate and property that is used in fishing activities, a share of a Corporation that is carrying on a fishing business, or an interest in a Partnership that is carrying on a fishing business.

**Fixed Term Annuity** An Annuity that is paid for a specified number of periods.

**Flat Tax System** A tax on Income that is applied at the same rate to all Taxpayers, without regard to the level of their Income.

**Foreign Accrual Property Income (FAPI)** Income of a Controlled Foreign Affiliate from property (interest, Dividends, rents, royalties), Income from inactive businesses, Taxable Capital Gains from properties not used in an Active Business, and Income from an investment business, defined as a business the principal purpose of which is to earn Property Income.

**Foreign Affiliate** A non-resident Corporation in which a Canadian Taxpayer has an equity percentage of at least 1 percent. As well, the aggregate equity percentages of the Taxpayer and each Person related to the Taxpayer must be at least 10 percent.

**Foreign Taxes Paid Credit** A credit against Tax Payable based on taxes withheld by a foreign taxing authority on foreign source income.

**Former Business Property** Real property that is used in the operation of a business.

**Fringe Benefits** Non-cash benefits provided to Employees by an employer (e.g., contributions to an Employee's Registered Pension Plan).

**Full Rate Taxable Income** For purposes of calculating the General Rate Reduction, Taxable Income reduced by amounts which have received preferential treatment under some other provision (e.g., the Small Business Deduction).

**Fully Taxable Goods And Services** Goods and services that are taxable at the full 5% GST rate. Registrants who sell Fully Taxable Goods And Services are entitled to Input Tax Credits for GST paid. Examples include clothing, furniture, legal fees, hydro services, building materials, and restaurant meals.

## G

**GAAP** An acronym for "generally accepted accounting principles".

**GAAR** An acronym for "general anti-avoidance rule". This ITA 245 provision attempts, in a very generalized manner, to limit the ability of Taxpayers to avoid tax through certain types of transactions that have no bona fide purpose other than to obtain a tax benefit.

**General Partner** A Partner whose personal liability for the debts and obligations of the partnership are not limited.

**General Partnership** A Partnership, all of the members of which are General Partners.

**General Rate Income Pool (GRIP)** A notional account that tracks amounts of a CCPC's income that can be used for the payment of Eligible Dividends.

**General Rate Reduction** A percentage point deduction in the calculation of corporate Tax Payable that is designed to reduce the general corporate tax rate of 38 percent.

**Gift** A voluntary Transfer of goods or services without remuneration.

**Goods And Services Tax (GST)** A type of Transaction Tax that is assessed on the sale of goods and services. As it is assessed at all stages of the production/distribution chain, the tax that an enterprise must collect and pay to the government is offset by Input Tax Credits for the tax paid on the various inputs required to produce or distribute the goods and services.

**Goodwill** The excess, if any, of the total fair value of a business enterprise, over the sum of the fair values of its identifiable tangible and intangible assets.

**Graduated Rate Estate** A testamentary trust that is designated as a graduated rate estate. Its special features include the ability to use graduated tax rates and a non-calendar fiscal period for the 36 month period following an individual's death.

**Grind** A programmed reduction in some specified tax variable (e.g. the spousal tax credit is ground down by the spouse's Net Income For Tax Purposes).

**Gross Cost** For purposes of calculating Capital Cost in the determination of the M&P Deduction, this is the cost of Capital Assets, without the deduction of government grants or Investment Tax Credits.

**Group Of Persons** For purposes of determining Control of a Corporation, a Group Of Persons is any two or more Persons, each of whom owns shares in the Corporation.

**GST** An acronym for the "goods and services tax".

**GST Tax Credit** A Refundable Tax Credit that is available to all Resident Individuals aged 19 or older who file a T1 tax return. May be reduced or eliminated by a deduction of Income in excess of a threshold amount.

## H

**Half-Year Rules (a.k.a. First Year Rules)** A group of rules which require the subtraction of one-half of the year's net additions (additions, less the amount subtracted from the class because of disposals) from the Class, prior to calculating the CCA for the year. The great majority of post-2018 capital asset acquisitions are eligible for the Accelerated Investment Incentive (AccII) so the Half-Year Rules don't apply to those acquisitions.

**Harmonized Sales Tax (HST)** A combined federal/provincial sales tax that is generally assessed on the same basis as the federal Goods And Services Tax (GST). The combined rate varies across the provinces and is notionally a combination of the 5% GST plus a provincial sales tax ranging from 7% to 10%.

**Head Tax** A tax levied on the Individuals that are included in a specified classification.

**Hobby Farmer** A part-time farmer who does not have a Reasonable Expectation Of Profit.

**Home Accessibility Tax Credit** A tax credit that is available on expenditures made for renovations that will allow seniors and disabled individuals to gain access to, or be more mobile within a dwelling.

**Home Buyers' Plan (HBP)** A provision that allows Individuals to make a temporary, non-taxable withdrawal from their RRSP for purposes of acquiring a residence.

## I

**Identical Property Rules** Rules which require that, for a group of identical Capital Assets (e.g., Common Shares) acquired at different prices, the Adjusted Cost Base used to determine the gain or loss will be the average cost of the group. The rules are used when there is a partial Disposition of the group.

**Immigration** Entering a new country, usually for purposes of establishing permanent residence.

**Imputed Interest** Interest on outstanding debt calculated at a specified interest rate without regard to the actual interest rate being paid. This concept is used to determine the Taxable Benefit on loans to Employees and Shareholders.

**Inadequate Consideration** A term used to refer to a situation where a non-arm's length transfer of property has been made and the Proceeds Of Disposition are not equal to the fair market value.

**Income** A measure of either how much an entity has earned during a period or, alternatively, how much its net worth has increased during a period. As the term is used in accounting and tax, it is a rules-based calculation. In the case of accounting, the rules are referred to as generally accepted accounting principles (GAAP), while in tax the rules are found in the *Income Tax Act* and other sources.

**Income Attribution** The allocation of some types of Income, on assets that have been transferred to a Spouse or related minors, back to the Transferor for inclusion in the Transferor's Net Income For Tax Purposes.

**Income Interest (In A Trust)** A right of the Taxpayer as a Beneficiary under a Personal Trust to receive all or any part of the Income of the Trust.

**Income Splitting** A group of Tax Planning techniques designed to divide a given stream of Income among family members or other related parties. The value of these techniques is based on progressive tax rates which means that, if a stream of Income can be divided into a group of smaller streams, a larger portion of it will be taxed at lower rates, resulting in aggregate tax savings.

**Income Tax** A tax on the Income of certain defined entities.

**Income Tax Application Rules** A set of rules designed to deal with transitional problems associated with the introduction of Capital Gains taxation in 1972. While these rules were very important in the years immediately after 1971, they are of declining importance at this point in time.

**Income Tax Folios** A CRA publication providing their interpretation of various technical issues related to income taxes. These will gradually replace the CRA's Interpretation Bulletins.

**Income Tax Regulations** A set of rules concerning administration and enforcement of the *Income Tax Act*. One of the major issues covered here is Capital Cost Allowance rates and procedures.

**Income Tax Technical News** An irregularly published newsletter prepared by the Income Tax Rulings Directorate.

**Income Trust** A Trust that has sold its beneficial interest units to the public in order to raise funds to acquire a business operation. All cash flows from the business are distributed to the unit holders.

**Indexation** The process of adjusting tax brackets and some Tax Credits to reflect changes in the consumer price index.

**Individual** A single human being.

**Individual Pension Plan** A defined benefit pension plan established for one individual.

**Information Circulars** A group of separate publications that provides information regarding procedural matters that relate to both the *Income Tax Act* and the provisions of the Canada Pension Plan.

**Information Return** ITA 221(1)(d) gives the CRA the right to require any class of Taxpayer to file a return providing any class of information that it would like to have. A common example of an Information Return would be the T4 which employers are required to file in order to provide information on their Employees' earnings and withholdings.

**Input Tax Credit (ITC)** An amount, claimable by a registrant, for GST paid or payable on goods or services that were acquired or imported for consumption, use, or supply in the course of the Registrant's Commercial Activity.

**Instalment Threshold** An amount, currently $3,000 of net tax owing for Individuals or taxes payable for Corporations that is used to determine the need to make Instalment payments (i.e., Individuals are required to make Instalment payments if their Net Tax Owing in the current year and one of the two preceding years exceeds the Instalment Threshold of $3,000).

**Instalments** Payments made during a taxation year by both Individuals and Corporations. They are designed to accumulate to an amount sufficient to cover the tax liability for the year. Individuals and Small CCPCs make quarterly Instalments. Corporations that are not Small CCPCs are required to remit monthly.

**Integration** An approach to the taxation of Corporations that attempts to ensure that amounts of Income that are flowed through a Corporation to its Individual shareholders, are subject to the same amount of tax as would be the case if the Individuals had received the Income directly from its source.

**Inter Vivos Transfer** A Transfer made by a living Individual, as opposed to a Transfer made subsequent to that Individual's death.

**Inter Vivos Trust** A Trust that is not a Testamentary Trust.

**Interest Income** An amount that represents compensation for the use of money, is calculated with reference to a principal sum, and that accrues on a continuous basis.

**International Tax Treaty (a.k.a., International Tax Convention)** A bilateral agreement between two countries which establishes rules for dealing with cross-jurisdictional tax issues.

**International Taxation** Income and other types of taxation related to transactions and events that take place in multiple jurisdictions.

**Interpretation Bulletins** A group of over 500 individual publications which provides the CRA's interpretation of the various laws that they administer. Gradually being replaced by Income Tax Folios.

**In-The-Money** A term that is used to describe stock options in situations where the fair market value of the stock exceeds the option price.

**Inventory** Property, the cost or value of which is relevant in computing a taxpayer's income from a business for a taxation year. The property is being held for resale, as opposed to being held to produce income.

**Investment Tax Credit** A credit against Tax Payable, calculated as a percentage of some specified type of expenditure made by the Taxpayer.

**Involuntary Disposition** A Disposition of a capital property resulting from theft, destruction through natural causes, or expropriation by a statutory authority.

## J

**Joint Spousal Or Common-Law Partner Trust** An Inter Vivos Trust established by an Individual aged 65 years or more, subject to the conditions that the Individual and his/her Spouse or Common-Law Partner must be entitled to all of the Trust's Income during their lifetimes, and the Individual and his Spouse or Common-Law Partner must be the only Individuals who can access the capital of the Trust during his/her lifetime.

**Joint Tenancy** A holding of property, either real or personal, by two or more Persons with each sharing the undivided interest that cannot be sold without the consent of all joint tenants.

**Joint Venture** An arrangement in which two or more Persons work together in a limited and defined business undertaking, which does not constitute a Partnership, a Trust, or a Corporation, the expenses and revenues of which will be distributed in mutually agreed portions.

## L

**Labour Sponsored Funds Tax Credit** A credit against Tax Payable that is available to Individuals making investments in prescribed labour sponsored venture capital corporations.

**Legal Stated Capital** An amount that is specified in corporate enabling legislation. In general, it is equal to the amount of consideration received for the issuance of shares.

**Life Annuity** An Annuity that continues until the death of the Annuitant.

**Lifelong Learning Plan (LLP)** A provision that allows Individuals to make temporary, non-taxable withdrawals from their RRSP when they are enrolled in a qualifying education program at a qualifying educational institution.

**Lifetime Capital Gains Deduction** A deduction in the calculation of the Taxable Income of an Individual. It permits the deduction of a cumulative lifetime amount of Capital Gains resulting from the Disposition of Qualified Small Business Corporation shares or Qualified Farm or Fishing Property.

**Limited Liability** A reference to the fact that the liability of investors in equity shares of a Corporation is limited to the amount of their invested capital.

**Limited Liability Partnerships** A Partnership, all of the members of which are legislatively specified professionals. The members of such Partnerships are relieved of any personal liability arising from the wrongful or negligent action of their professional Partners, as well as Employees, agents, or representatives of the Partnership who conduct partnership business.

**Limited Partner** As defined in most provincial legislation, a Partner whose liabilities for partnership debts is limited to the amount of his contribution to the Partnership, and who is not permitted to participate in the management of the Partnership.

**Limited Partnership** A Partnership composed of at least one General Partner and at least one Limited Partner. To be considered a Limited Partnership, the Partnership has to be registered as such under the appropriate provincial registry.

**Limited Partnership Loss** The excess of losses allocated to a Limited Partner (other than farming or capital losses), over his At-Risk Amount.

**Liquidating Dividend** A Dividend that represents a return of invested capital, as opposed to a distribution from earnings.

**Listed Personal Property** A defined subset of Personal Use Property. The included items are works of art, jewelry, rare books, stamps, and coins.

**Loss Carry Back** The application of a loss incurred in the current taxation year against the Income reported in a previous taxation year, resulting in a refund of taxes paid in that previous year.

**Loss Carry Forward** The application of a loss incurred in the current taxation year against Income reported in a subsequent taxation year, resulting in a reduction of Tax Payable in that subsequent year.

**Low Rate Income Pool (LRIP)** A notional account that tracks amounts of a non-CCPC's income that cannot be used for the payment of Eligible Dividends.

**Lump-Sum Payments** Retroactive payments for Spousal or Child Support, pension benefits, EI benefits, and Employment Income (including payments for termination), that relate to prior years. Qualifying amounts of such payments are eligible for an alternative Tax Payable calculation.

## M

**M&P** An acronym for "manufacturing and processing" usually used in connection with the calculation of the Manufacturing And Processing Profits Deduction.

**M&P Capital** 100/85 of the Cost Of Capital related to Qualified Activities for M&P.

**M&P Labour** 100/75 of the Cost Of Labour related to Qualified Activities for M&P.

**M&P Profits** A concept of Income based on M&P Capital and M&P Labour, applied in a formula contained in ITR 5200.

**Manufacturing And Processing Profits Deduction (M&P Deduction)** A deduction in the calculation of corporate Tax Payable. It is equal to the General Rate Reduction rate applied to M&P Profits.

**Median Rule** A rule applicable to Capital Assets acquired before 1972. For purposes of calculating Capital Gains on Dispositions of these assets, the Adjusted Cost Base is equal to the median of the cost of the asset, the Valuation Day value of the asset, and the Proceeds Of Disposition.

**Medical Expense Tax Credit** A credit against Tax Payable that is available to Individuals with qualifying medical expenses.

**Merger** A combination of two or more business enterprises. While widely used in the *Income Tax Act*, this term does not have a formal definition in that legislation.

**Money Purchase Limit** An amount, specified in tax legislation that represents the maximum amount of Employee and employer contributions that can be added, for the benefit of a given Employee, to an RPP in the specified taxation year.

**Money Purchase Plan (a.k.a., Defined Contribution Plan)** A retirement savings plan in which the plan sponsor (employer or Individual) makes known or determinable contributions. The retirement benefit is based on the accumulated contributions and earnings on investments within the plan.

**Moving Expenses** Costs, as described in ITA 62(3), that can be deducted when an Individual is moving; to a new work location, to commence full-time attendance at a post-secondary institution, to a new work location after ceasing to be a full-time student at a post-secondary institution, or to a new location to take up employment, if unemployed prior to the move.

**MUSH** An acronym for "municipalities, universities, schools, and hospitals". It is used in GST work to refer to the special rules applicable to these organizations.

**Mutual Fund** A taxable entity, either a Trust or a Corporation, that manages a portfolio of investments on behalf of its unitholders or shareholders.

## N

**"Negative" Adjusted Cost Base** A term used to refer to situations where negative adjustments to the Adjusted Cost Base of a Capital Asset exceed its original cost plus positive adjustments. While, in general, such amounts must be taken into Income, an exception is made for Partnership Interests, for which such amounts can be carried forward.

**Net Assets** Assets minus the liabilities of a business enterprise.

**Net Business Income** As used in this text, the net of inclusions less deductions, related to Business Income, with all amounts determined as per Division B, Subdivision b, of the *Income Tax Act*.

**Net Capital Loss** The excess of Allowable Capital Losses over Taxable Capital Gains for the current year.

**Net Income** As used in this text, the net of revenues plus gains, less expenses plus losses, with all amounts determined through the application of GAAP.

**Net Income For Tax Purposes** The sum of Employment Income, Business and Property Income, net Taxable Capital Gains, other sources of income, and other deductions from income, determined using income tax procedures and concepts. These amounts are combined as per the rules in ITA 3. This amount is also referred to as Division B Income or simply Net Income. However, we tend to use the full Net Income For Tax Purposes title in order to avoid confusion with Net Income as determined by accounting rules.

**Net Property Income** As used in this text, the net of inclusions less deductions, related to Property Income, with all amounts determined as per Division B, Subdivision b, of the *Income Tax Act*.

**Net Tax Owing** A term, applicable to Taxpayers who are Individuals, used to describe the sum of federal and provincial taxes owing for the year, less amounts withheld for the year.

**NETFILE** An electronic filing system that requires the use of an approved software program. An Individual uses the Internet to transmit their return directly to the CRA, without the use of a third party.

**New Housing GST Rebate** A provision that allows an individual to recover a portion of the GST paid on the acquisition of a new residence.

**Non-Arm's Length** ITA 251(1) indicates that Related Persons (see definition) do not deal with each other at arm's length. Also, a taxpayer and a personal trust do not deal with each other at arm's length. In other cases, it is a question of fact as to whether an arm's length relation exists.

**Non-Capital Loss** The sum of employment losses (for Individuals), business losses, property losses, Net Capital Losses deducted, and deductible Dividends received (for Corporations), less Income as calculated under ITA 3(c).

**Non-Depreciable Capital Property** Capital property, such as land or holdings of securities, that is not subject to depreciation or amortization.

**Non-Discretionary Trust** A Trust for which the Trust documents have specified the amounts of Income and capital to be allocated to each Beneficiary.

**Non-Eligible Dividends** Dividends that have not been designated by the payor as eligible for the enhanced gross up and tax credit procedure.

**Non-Eligible RDTOH** A balance containing refundable taxes that are available for dividend refunds on non-eligible dividends paid.

**Non-Portfolio Property** (Definition relevant only to SIFT entities) These properties are made up of (1) securities of a subject entity (corporation, trust, or partnership) where the securities held have a value that is greater than 10% of the equity value of the subject entity or, the securities held, along with securities of entities affiliated with the subject entity, have a fair market value that is greater than 50% of the equity value of the trust or partnership, (2) real estate and resource properties where such properties total more than 50% of the equity value of the trust or partnership, and (3) property used in the course of carrying on a business in Canada.

**Non-Refundable Tax Credit** A Tax Credit that can only be used against the Tax Payable of an Individual. It will not be "refunded" to Individuals without sufficient Tax Payable to make use of it.

**Non-Resident** A Corporation, Trust, or any other type of entity that exists, was formed or organized, or was last continued under the laws of a country, or a political subdivision of a country, other than Canada.

**Non-Share Consideration** Consideration received by a Taxpayer from a Corporation that is in the form of assets other than shares of the Corporation.

**Northern Residents Deductions** Deductions from the Taxable Income of residents of prescribed areas in northern Canada, designed to compensate them for the higher costs of living in these regions.

**Notice Of Assessment** A form that the CRA sends to all Taxpayers after they process their returns. It tells Taxpayers whether there were any changes made to the returns and, if so, what they are. It also informs Taxpayers of the amount of their additional tax payable or their refund.

**Notice Of Objection** A statement made to the CRA which provides a statement of facts and reasons, detailing why a Taxpayer or GST Registrant disagrees with an Assessment. The notice can be filed using Form T400A or by simply writing a letter to the CRA.

## O

**OAS Clawback** A taxing back, or reduction, in the payment of Old Age Security benefits. The federal government taxes back, or retains, an amount of these payments equal to 15% of the Individual's Income in excess of an indexed threshold amount.

**Old Age Security Benefits (OAS)** A monthly payment to Residents of Canada who are 65 years of age or older (see also OAS Clawback).

**Operating Cost Benefit** A Taxable Benefit assessed to Employees whose employers pay the operating costs of an automobile provided to the Employee. It is designed to reflect, on a notional basis, the value of these operating costs.

**Ordering Rule** Rules which establish the sequence or order in which a group of deductions must be made.

**Over Integration** An application of integration procedures (e.g., gross up and dividend tax credit rates) that results in a situation where income flowed through a corporation is subject to less tax payable than the same income received directly by an individual.

## P

**Paid Up Capital (PUC)** A balance that is, in general, equal to Legal Stated Capital as determined under the legislation governing the particular Corporation. The equivalent of Contributed Capital in accounting usage.

**Parent Company** A Corporation that Controls one or more Subsidiaries.

**Part IV Tax** A refundable tax, applicable to Private Corporations and Subject Corporations, and assessed on Portfolio Dividends received as well as some Dividends received from Connected Corporations.

**Part Year Resident** An Individual who either enters Canada during the year and becomes a Resident or, alternatively, an Individual who departs from Canada during the year and gives up their Resident status. In either case, the Individual will be taxed on their worldwide income for the part of the year that they were considered to be a Resident of Canada.

**Partner** A Person who is a member of a Partnership.

**Partner and Employee GST Rebate** A provision that allows partners and employees to recover the GST paid on their partnership or employment related expenses.

**Partnership** Two or more Persons who combine forces to carry on a business together for the purpose of making a profit by contributing their skills, knowledge, labour, experience, time, or capital.

**Partnership Interest** A Non-Depreciable Capital Property that reflects the Partner's original cost, adjusted for earnings, withdrawals, and other factors.

**Past Service Cost** The cost of starting a pension plan and extending the benefits/contributions to years of service prior to the inception of the plan or, alternatively, amending the benefit/contribution formula of an existing plan and extending the change retroactively to years of service prior to the amendment.

**Past Service Pension Adjustment (PSPA)** An adjustment to reflect the past service benefits/contributions allocated to an Employee for years of service prior to the current year.

**Penalties** Amounts taxpayers or GST registrants must pay if they fail to file returns or remit or pay amounts owing on time, or if they try to evade paying or remitting tax by not filing returns. Penalties must also be paid by people who knowingly, or under circumstances amounting to gross negligence, participate in or make false statements or omissions in their returns, and by those who do not provide the information required on a prescribed form.

**Pension Adjustment (PA)** An adjustment reported by employers which reflects, for an individual Employee, the Employee and employer contributions to RPPs and DPSPs for the previous year (in the case of Defined Benefit RPPs, benefits are converted to an equivalent amount of contributions).

**Pension Adjustment Reversal (PAR)** An adjustment for amounts of benefits/contributions that were included in previously issued Pension Adjustments, but have subsequently been lost to the Individual (e.g., benefits earned during a pre-vesting period that did not ultimately vest).

**Pension Income Tax Credit** A credit against Tax Payable that is available to Individuals with qualifying pension income.

**Periodic Child Care Expense Amount** A weekly limit on deductible child care costs, defined as 1/40 of the Annual Child Care Expense Amount.

**Permanent Establishment** A fixed place of business of a Corporation, including an office, a branch, a mine, an oil well, a farm, a timberland, a factory, a workshop, or a warehouse.

**Person** A term used in the *Income Tax Act* to refer to taxable entities. For income tax purposes, the three taxable entities are Individuals, Corporations, and Trusts.

**Personal Services Business** A Corporation that provides the services of a Specified Shareholder [ITA 248(1)] who could reasonably be regarded as an officer or Employee of the business, and that does not have five or more other full time Employees throughout the year.

**Personal Tax Credits** A group of credits against Tax Payable that are specified in ITA 118(1). They include credits for Individuals, Spouses, Common-Law Partners and various Dependants, as well as credits for types of income such as pension or employment.

**Personal Trust** A Testamentary or Inter Vivos Trust in which no beneficial interest was acquired for consideration paid to the Trust or to a Person who contributed property to the Trust.

**Personal Use Property** Any property that is owned by the Taxpayer and used primarily for his enjoyment, or for the enjoyment of one or more Individuals Related to the Taxpayer.

**Phased Retirement** A term used to refer to situations where an individual over 55 years of age continues to earn partial pension benefits, despite the fact that he or she has started to receive pension benefits from that employer.

**Political Contributions Tax Credit** A credit against Tax Payable that is available to Individuals who have made contributions to a registered federal political party or to a candidate at the time of a federal election.

**Pooled Registered Pension Plan** A registered pension plan established by a financial institution. Eligible registrants would be employees and other individuals who are not members of a registered pension plan established by an employer.

**Portfolio Dividend** A Dividend received from a Corporation to which the recipient is not connected (see Connected Corporation). Usually applicable if 10% or less of the voting shares are owned.

**Post-1971 Undistributed Surplus** Amounts earned by a Corporation after 1971 and retained in the Corporation.

**Pre-1972 Capital Surplus On Hand** Capital Gains accrued before 1972 that have been realized as the result of a Disposition after 1971, less Capital Losses that accrued before 1972 that have been realized as the result of a Disposition after 1971.

**Pre-1972 Undistributed Surplus** Amounts earned by a Corporation prior to 1972 and retained in the Corporation.

**Preferred Beneficiary** An Individual who is a Beneficiary of a Trust and who is either eligible for the Disability Tax Credit or, alternatively, 18 years of age or older and can be claimed by another Individual for purposes of the dependant tax credit for Individuals who are dependant because of mental or physical infirmity.

**Preferred Beneficiary Election** An Election which allows trust income to be allocated to a Preferred Beneficiary without being distributed to that Beneficiary by the Trust.

**Preferred Shares** Shares that do not have all the rights which are provided for under the relevant corporate enabling legislation. While there are many variations in the rights that such securities have, Preferred Shares would normally have a fixed or determinable Dividend and would not have voting rights.

**Prescribed Debt Obligations** A group of non-standard debt contracts that are defined in ITR 7001 (e.g., a debt contract with no interest stipulated as payable).

**Prescribed Proxy Amount** An alternative basis for calculating Scientific Research And Experimental Development overhead costs. Instead of calculating actual overhead costs, a Prescribed Proxy Amount, based on 65% of the Salaries and wages of Employees involved in Scientific Research And Experimental Development activities, can be used.

**Prescribed Rate** An interest rate which, as described in ITR 4301, changes quarterly and is based on the average interest rate paid on 90 day Treasury Bills during the first month of the preceding quarter. The basic rate is used for a variety of purposes (e.g., calculation of the Taxable Benefits on interest free loans to Employees). The basic rate, plus 2 percentage points, is used to calculate interest owing from the government to Taxpayers (e.g., interest on late payment of a tax refund). The basic rate, plus 4 percentage points, is used to calculate interest owed by Taxpayers to the government (e.g., interest on late Instalments).

**Prescribed Stock Exchange** This term has been replaced by “designated stock exchange”.

**Principal Residence** Any accommodation owned by the Taxpayer that was ordinarily inhabited in the year by the Taxpayer, his Spouse, a former Spouse, or a dependent child, and is designated by the Taxpayer as a Principal Residence.

**Private Corporation** A Corporation that is a resident of Canada, but is not a Public Corporation.

**Proceeds Of Disposition** Amounts received as the result of a Disposition. Usually related to a capital property Disposition.

**Professional Corporation** ITA 248(1) defines a Professional Corporation as a Corporation that carries on the professional practice of an accountant, dentist, lawyer, medical doctor, veterinarian, or chiropractor. Corporations carrying on the practice of other professionals, for example architects, do not fall within this definition.

**Profit Sharing Plan** A trusteed plan to which employers can make deductible contributions, the amount of which is related to the profits of the enterprise. Both the contributions and the earnings resulting from their investment are taxed in the hands of the Employees as they occur. Payments from the plan are received by the Employees on a tax free basis.

**Progressive Tax System** A tax system that applies higher effective rates for Individuals with higher Incomes and lower effective rates for Individuals with lower Incomes (e.g., personal income taxes).

**Property Income** Income that is earned through the passive ownership of property. It would include rents, interest, Dividends, and some royalties (i.e., royalties paid on assets that have been purchased). While usage is not always consistent, this term usually refers to a net amount (i.e., inclusions less deductions, or revenues less expenses).

**Property Tax** A tax on the ownership of some particular set of goods.

**Public Corporation** A Corporation that has at least one class of its shares listed on a designated stock exchange in Canada.

**PUC** An acronym for "paid up capital".

**Purification Of A Small Business Corporation** A process of disposing of corporate assets that are not being used to produce Active Business Income, so that the Corporation meets the 90% of assets test required to qualify as a Small Business Corporation.

## Q

**Qualified Activities** Types of activity, as defined in ITR 5202, that are considered to be manufacturing and processing activities.

**Qualified Farm Property** A Qualified Farm Property is a Farm Property that, prior to its Disposition was owned by the Taxpayer, his Spouse, or his Common-Law Partner, or their children for a period of 24 months or more.

**Qualified Fishing Property** A Qualified Fishing Property is a Fishing Property that, prior to its Disposition was owned by the Taxpayer, his Spouse, or his Common-Law Partner, or their children for a period of 24 months or more.

**Qualified Property** Certain specified types of property that, when acquired, qualify the Taxpayer for an Investment Tax Credit.

**Qualified Scientific Research And Experimental Development Expenditures** Scientific Research And Experimental Development expenditures that qualify the Taxpayer for Investment Tax Credits.

**Qualified Small Business Corporation** A Small Business Corporation that, at the time of its Disposition, has been owned by no one other than the Taxpayer or a related party during the preceding 24 months, and during that 24 month period, more than 50% of the fair market value of its assets were used in an Active Business carried on primarily in Canada.

**Qualifying Canadian Journalism Organization** A Canadian organization that is primarily involved in the production of written news content.

**Qualifying Corporation** A CCPC throughout the year with Taxable Income in the immediately preceding year of no more than $500,000 and previous year Taxable Capital Employed In Canada of $10 million or less, thereby qualifying for the additional 15% tax credit on the first $3,000,000 of Qualified Scientific Research And Development Expenditures.

**Qualifying Spousal Or Common-Law Partner Trust** A Spousal Or Common-Law Partner Trust that qualifies for the Rollover of assets into the Trust under ITA 73(1.01) for Inter Vivos Trusts or ITA 70(6) for Testamentary Trusts.

**Qualitative Characteristics** This term is used in our text to refer to non-quantitative characteristics of a tax system that are considered to be desirable (e.g., fairness).

**Quick Method** A method of determining GST amounts payable or receivable that is available to Registrants with annual GST taxable sales, including those of associated businesses, of $400,000 or less. Specified percentages are applied to the GST inclusive sales figures to determine the GST payable or the refund. Accounting for Input Tax Credits on non-capital expenditures is not required. Input Tax Credits on capital expenditures are tracked separately.

## R

**RDTOH** An acronym for "refundable dividend tax on hand".

**Real Property** Land and all appurtenances to it, including buildings, crops, and mineral rights, a.k.a., real estate.

**Reasonable Expectation Of Profit (REOP)** A test that involves the determination of whether a business or an investment is likely to have a profit. The CRA has tried to use this test to limit the ability of Taxpayers to deduct losses resulting from businesses and investments that fail their REOP test.

**Reassessment** A revision of an original Assessment (see Assessment and Notice Of Assessment).

**Recapture Of CCA** An inclusion in Business and Property Income that arises when deductions from a CCA Class, engendered by disposals, leave a negative balance in that Class at the end of the taxation year.

**Redemption Of Shares** A transaction in which a Corporation purchases some of its own outstanding shares, either in the open market, or through a direct purchase from shareholders.

**Refundable Dividend Tax On Hand (RDTOH)** A balance made up of refundable taxes paid, less refunds received as the result of paying Dividends. There are two separate RDTOH balances, Eligible RDTOH and Non-Eligible RDTOH.

**Refundable Investment Tax Credit** An Investment Tax Credit that will be paid to the Taxpayer, even if the amount resulting from the Investment Tax Credit exceeds the Taxpayer's Tax Payable.

**Refundable Journalism Labour Tax Credit** A refundable credit for salaries and wages paid to Eligible Newsroom Employees of a Qualifying Canadian Journalism Organization.

**Refundable Medical Expense Supplement** A refundable credit against Tax Payable that increases the amount available to certain low income individuals for their eligible medical expenses.

**Refundable Part I Tax** The portion of Part I tax that is applicable to a notional amount of Aggregate Investment Income earned by a CCPC.

**Refundable Part XI.3 Tax** A 50% tax that is assessed on contributions to a Retirement Compensation Arrangement and on the earnings of amounts invested in the plan. It is fully refundable when amounts are distributed from the arrangement and taxed in the hands of the recipient Employees.

**Refundable Tax Credit** An amount, based on a Tax Credit calculation, that will be paid to an Individual even if the amount resulting from the Tax Credit calculation exceeds the Individual's Tax Payable.

**Registered Disability Savings Plan (RDSP)** A trusteed arrangement that allows Individuals to make non-deductible contributions that will be invested on a tax-free basis, with the accumulated funds being used to make distributions to an individual who qualifies for the disability tax credit.

**Registered Education Savings Plan (RESP)** A trusteed arrangement that allows Individuals to make non-deductible contributions that will be invested on a tax-free basis, with the accumulated funds being used to provide for the post-secondary education of a child.

**Registered Pension Plan (RPP)** A retirement savings plan sponsored by an employer, to which the employer will make contributions which are not taxable to the Employee, and the Employee may make contributions which are deductible. Earnings accumulate tax free within the plan. Withdrawals from the plan are subject to tax.

**Registered Retirement Income Fund (RRIF)** A trusteed plan to which a Resident Individual can transfer balances from retirement savings plans on a tax free basis. Earnings accumulate tax free within the plan. Withdrawals from the plan are subject to tax. Unlike RRSPs, a minimum withdrawal is required each year.

**Registered Retirement Savings Plan (RRSP)** A trusteed plan to which a Resident Individual can make deductible contributions. Earnings accumulate tax free within the plan. Withdrawals from the plan are generally subject to tax.

**Registrant** An entity who is registered to collect and remit the GST.

**Regressive Tax System** A tax system that applies higher effective rates for Individuals with lower Incomes and lower effective rates for Individuals with higher Incomes (e.g., most sales taxes).

**Related Persons** ITA 251(2)(a) indicates that two Individuals are related if they are connected by blood relationship, marriage or common-law partnership, or adoption. ITA 251(2)(b) describes various situations in which a Corporation would be related to other Persons (e.g., a Corporation is related to the Person who Controls it). ITA 251(2)(c) describes various situations in which two Corporations would be related to each other (e.g., the two Corporations are controlled by the same Person).

**Reorganization Of Capital (ITA 86)** A Rollover provision that allows one class of shares in a Corporation to be exchanged for a different class of shares, without tax consequences.

**Replacement Property Rules** A set of rules which provide for the deferral of both Recapture and Capital Gains on Involuntary Dispositions and some voluntary Dispositions of capital property. Deferral is conditional on replacing the property within a specified period after the Proceeds Of Disposition are received.

**Reserve** A deduction in the calculation of net Business Income or net Taxable Capital Gains.

**Resident** A Person who is located in a place. This is the basis on which Canadian income taxes are assessed. That is, Canadian Resident Persons are liable for the payment of Canadian income tax, without regard to their citizenship or the source of their Income. While not defined in the *Income Tax Act*, IT Folio S5-F1-C1 provides guidance on the determination of residency for Individuals and IT-447 provides similar guidance for Trusts.

**Residential Ties** Factors that will be considered in determining whether or not an Individual is a Resident of Canada. While there are many such ties, ITF S5-F1-C1 indicates that the most commonly used would be the maintenance of a dwelling in Canada, having one's Spouse or Common-Law Partner remain in Canada, and having one's Dependants remain in Canada.

**Restricted Farm Loss** A farmer whose chief source of Income is not farming or a combination of farming and some other source of Income, but who has a reasonable expectation of long-run profitability, can only deduct losses to the extent of the first $2,500, plus one-half of the next $12,500. Losses in excess of this deductible amount are referred to as Restricted Farm Losses.

**Restrictive Covenant** An agreement entered into, an undertaking made, or a waiver of an advantage or right by the Taxpayer. This would include, but would not be limited to, non-competition agreements.

**Retained Earnings (a.k.a. Earned Capital)** In accounting usage, the amount of a Corporation's Shareholders' Equity that resulted from the retention of earnings in the Corporation.

**Retirement Compensation Arrangement** An unregistered plan to which employers make deductible contributions to provide Employees with benefits subsequent to their retirement. Both contributions and earnings are subject to a Refundable Part XI.3 Tax.

**Retiring Allowance** Amounts received at retirement as recognition for long service, or as the result of loss of employment.

**Reversionary Trust** A trust agreement under which the property held by the Trustee can revert to the Settlor.

**Rights Or Things** With respect to a deceased Taxpayer, these are amounts that are due, but have not been received (e.g., wages to the end of a pay period prior to death, but not yet received).

**Rollover** As this term is used in tax work, it refers to a tax free Transfer of assets under circumstances that, in the absence of a special Rollover provision, would be considered a taxable Transfer.

**RRSP Deduction Limit** The amount that is the sum of the Unused RRSP Deduction Room at the end of the preceding year, plus the amount by which the lesser of the RRSP Dollar Limit and 18% of Earned Income for the preceding year exceeds the Pension Adjustment for the preceding year. This sum is adjusted for any Past Service Pension Adjustment or Pension Adjustment Reversal. In simplified terms, it represents the maximum amount of contributions that have been made to an RRSP that can be deducted for a year.

**RRSP Deduction Room** The excess of the RRSP Deduction Limit, over the amount of RRSP contributions that have been deducted.

**RRSP Dollar Limit** Generally, the Money Purchase Limit for the preceding year.

## S

**Safe Income** For purposes of applying ITA 55(2) to Capital Gains Stripping, Safe Income is made up of amounts earned by a Corporation after 1971, or if the investment shares in that Corporation were acquired after that date, amounts earned after the acquisition.

**Salary** The amount an employer pays an Employee for work done. An employer records this type of Employment Income on a T4. A common component of Employment Income.

**Salary Deferral Arrangement** An arrangement, whether funded or not, under which an Individual who has the right to receive compensation postpones the receipt of that compensation, and it is reasonable to assume that one of the main purposes of this postponement was to defer the payment of taxes.

**Scientific Research And Experimental Development (SR&ED)** Activities related to basic or applied research, and for the development of new products and processes.

**Self-Employed Individual** An Individual who has a business relationship with an entity. Whether or not an Individual is working as an Employee or a Self-Employed Individual is dependent on factors such as control, ownership of tools, chance of profit or risk of loss, and the ability to subcontract or hire an assistant.

**Separate Class Rules** Rules that require certain types of assets that would, in the absence of these special rules, be included in a single Class, be allocated to a separate balance for that Class (e.g., each rental property with a cost greater than $50,000 must be placed in a different Class 1).

**Settlor** The Individual who creates a Trust by contributing property to be managed and administered by a Trustee for the Beneficiaries.

**Share For Share Exchange (ITA 85.1)** A Rollover provision that allows one Corporation to acquire shares in another Corporation by issuing its own shares, without tax consequences to either of the Corporations or their shareholders.

**Shared Use Capital Equipment** Capital Assets that are used more than 50 percent, but less than 90 percent, in Scientific Research And Experimental Development activities.

**Shareholders' Equity** The residual interest of the shareholders of a Corporation in the Net Assets of the Corporation.

**Short Fiscal Year** A taxation year that is less than 12 months in duration. Can occur in the first and last years of operation, as well as certain other situations.

**SIFT Partnership** To be a Specified Investment Flow-Through (SIFT) partnership, (1) the partnership must be a Canadian resident partnership; (2) investments in the partnership must be publicly traded; and (3) the partnership must hold one or more non-portfolio properties.

**SIFT Trust** To be a Specified Investment Flow-Through (SIFT) trust, (1) the trust must be resident in Canada; (2) investments in the trust must be publicly traded; and (3) the trust must hold one or more non-portfolio properties.

**Simplified ITC Accounting** A method of determining Input Tax Credits available to small businesses, charities, not-for-profit organizations, and certain public service bodies. The organization must have annual GST taxable sales, including those of associated businesses, of $1,000,000 or less and annual GST taxable purchases of $4,000,000 or less. Input Tax Credits are determined by multiplying all GST inclusive purchases, except real property purchases, by 5/105 rather than using the actual GST paid. Input Tax Credits on real property are tracked separately.

**Small Business Corporation** A Corporation that is a Canadian Controlled Private Corporation that uses all or substantially all (90% or more) of the fair market value of its assets in an Active Business that is carried on primarily (more than 50 percent) in Canada.

**Small Business Deduction** A deduction in the calculation of corporate Tax Payable equal to 17.5 percentage points on the first $500,000 of Active Business Income earned by a CCPC.

**Small CCPC** A Canadian Controlled Private Corporation that has (1) Taxable Income in the current or previous year of $500,000 or less, (2) has Taxable Capital Employed In Canada in the current or previous year of $10 million or less, (3) is able to claim some amount of the Small Business Deduction in the current or previous year, and (4) has a perfect payment compliance record for the last 12 months.

**Small Suppliers Exemption** An exemption from the requirement to register for the collection and remittance of GST for those entities with less than $30,000 in taxable supplies.

**Social Benefits Repayment (a.k.a., Clawback)** An income tested taxing back, or reduction, in the payment of Old Age Security Benefits and Employment Insurance Benefits.

**Soft Costs** Costs, such as interest and property tax, on land and buildings that are incurred prior to the capital asset being used for business or income producing purposes.

**Sojourner** An Individual who is deemed under ITA 250 to be a Canadian Resident for the full taxation year as the result of having sojourned (i.e., been temporarily present) in Canada for 183 days or more.

**Source Deductions** Amounts that are withheld by an employer from the Income of Employees. The withholdings for income taxes, Canada Pension Plan contributions, and Employment Insurance premiums must be remitted to the government.

**Source Individual** A Source Individual (with respect to a Specified Individual) is a resident of Canada who is related to the Specified Individual.

**Specified Class [ITA 256(1.1)]** A class of shares that has certain specified terms and conditions, including a fixed or determinable Dividend and an absence of voting rights. Would generally be referred to as Preferred Shares.

**Specified Employee** An Employee who owns 10% or more of the shares of the Corporation, or who does not deal at arm's length with the Corporation.

**Specified Individual** Under the Tax On Split Income (TOSI) legislation a Specified Individual is an individual who is a resident of Canada and, if the individual is under 18, has a parent who is also a resident of Canada.

**Specified Investment Business** A Corporation that does not have five or more full time Employees throughout the year, whose principal purpose is to derive Income from property.

**Specified Non-Resident Shareholder** A specified shareholder who is a non-resident Person or non-resident investment company.

**Specified Shareholder [(ITA 18(5)]** A shareholder of a Corporation who owns, either alone or together with other related persons, more than 25% of the voting shares of a corporation or, alternatively, shares that have more than 25% of the market value of all of the corporation's shares.

**Specified Shareholder [ITA 248(1)]** A shareholder of a Corporation who owns, directly or indirectly, at any time in the year, not less than 10% of the issued shares of any class of the capital stock of the Corporation, or of any other Corporation that is related to the Corporation.

**Split Income** Certain types of Income received by a Specified Individual from non-arm's length sources that will be taxed at the maximum federal rate.

**Spousal Or Common-Law Partner Trust** An Inter Vivos or Testamentary Trust that has an individual's Spouse or Common-Law Partner as a Beneficiary (see also Qualifying Spousal Or Common-Law Partner Trust).

**Spousal RRSP** An RRSP to which the Spouse or Common-Law Partner of the Annuitant (i.e., Beneficiary of the RRSP) has made contributions that the Spouse or Common-Law Partner can deduct in calculating Net Income For Tax Purposes.

**Spousal Support** A Support Amount that is for the benefit of a Spouse or Common-Law Partner, or a former Spouse or Common-Law Partner.

**Spousal Tax Credit** A credit against Tax Payable that is available to individuals who have a Spouse or Common-Law Partner.

**Spouse** An Individual to whom a Taxpayer is legally married.

**Standby Charge** A Taxable Benefit assessed to Employees who have been provided with an automobile by their employer. It is designed to reflect, on a notional basis, the value of having the car available on a standby basis for personal usage.

**Stock Dividend** A pro rata distribution of corporation shares to existing shareholders of the corporation.

**Stock Option** A contractual arrangement which gives the holder the right to purchase a specified number of shares for a specified period of time at a specified acquisition price.

**Stop Loss Rules** A group of rules which, under specified conditions, prevent the deduction of a loss.

**Straight-Line Method** A method of calculating CCA in which a specified or determinable rate is applied to the Capital Cost of acquired assets in order to determine the CCA for the period.

**Student Loan Interest Tax Credit** A credit against Tax Payable that is based on the amount of interest on a loan under the *Canada Student Loans Act*, or the *Canada Student Financial Assistance Act*.

**Subject Corporation** For purposes of the Part IV Tax, a Public Corporation that is controlled by, or for the benefit of, an Individual or a related group of Individuals. Also used in the determination of Dividend Stripping (ITA 84.1) and share sales to non-residents (ITA 212.1) to describe a Corporation, the shares of which have been sold.

**Subsidiary** An enterprise that is controlled by another enterprise (the Parent Company). The Parent Company has the right and ability to obtain future economic benefits from the resources of the Subsidiary and is exposed to the related risks.

**Superficial Loss (ITA 54)** A loss on the Disposition of property that is disallowed for tax purposes because the Taxpayer has acquired an identical property, either 30 days before the Disposition or, alternatively, 30 days after the Disposition.

**Supply** A broad range of transactions between Persons. To "make a supply of property or a service" means to provide it in any way, including sale, transfer, barter, exchange, licence, rental, lease, gift, or Disposition.

**Support Amount** Amounts paid as the result of the separation or divorce of two Individuals who were Spouses or Common-Law Partners. Can be divided into Spousal Support and Child Support.

**Surtax** An additional or extra tax on something already taxed.

**Syndicates** A group of Persons combined or making a joint effort to undertake some specific project or to carry out a specific transaction.

## T

**Target Benefit Plan** A hybrid pension plan that is based on defined contributions combined with a target or proposed benefit for retirees. However, unlike defined benefit plans, these plans also allow the benefit to be reduced if funding is not adequate to produce the target benefit.

**Tariffs** A tax imposed on the importation or exportation of certain goods or services.

**Tax Avoidance** The undertaking of transactions or arrangements with a view to avoiding or minimizing the payment of taxes. As the term is generally used, it refers to legitimate procedures that could also be described as Tax Planning.

**Tax Base** The income source, class of transaction, type of property, or other factor on which tax is assessed (e.g., sales tax is assessed on sales).

**Tax Court Of Canada** A court that hears appeals about income tax and GST/HST assessments. In addition, the Court has jurisdiction to hear appeals under the Canada Pension Plan Act, Employment Insurance Act, and several other Acts. The Tax Court maintains four offices (Vancouver, Ottawa, Toronto, and Montreal) and regularly conducts hearings in major centres across Canada.

**Tax Credit** A credit against Tax Payable.

**Tax Deferral** An important type of Tax Planning. The basic idea here is to find procedures that will put off the payment of taxes until a later taxation year. The value of these procedures reflects the time value of money. That is, there is a value associated with making a payment later, rather than sooner.

**Tax Evasion** This typically involves deliberately ignoring a specific part of the law or willfully refusing to comply with legislated reporting requirements. Tax evasion, unlike tax avoidance, has criminal consequences.

**Tax Expenditures** Foregone tax revenues due to special exemptions, rate reductions, rebates, and credits that reduce the amount of tax that would otherwise be payable. Often designed to encourage certain kinds of activities or to serve other objectives, such as providing assistance to lower-income Canadians.

**Tax Free Savings Accounts (TFSAs)** A trusteed arrangement that allows Individuals to make non-deductible contributions that will be invested in qualified assets. Earnings accumulate on a tax free basis within the plan and can be distributed to the Individual who established the plan on a tax free basis.

**Tax Haven** A foreign country used to avoid or reduce income taxes, especially by investors from another country.

**Tax Incidence** The Person who ultimately pays a tax, regardless of the legal basis of assessment (e.g., taxes paid by Corporations may be passed on to either Employees or customers).

**Tax Planning** The undertaking of legitimate transactions or arrangements with a view to avoiding or minimizing the payment of taxes. Some or all of such efforts could also be referred to as Tax Avoidance.

**Tax Shelter (ITA 237.1)** The acquisition of a property, in respect of which it is represented that the acquisition of the property, or the donation or contribution of the property under a gifting arrangement, would generate any combination of tax credits or deductions that in total would equal or exceed the cost of acquiring the property.

**Tax Shelter (Other Meanings)** An investment that shelters Income from other sources (e.g., Employment Income) by producing tax losses, or an investment with a positive cash flow that is sheltered by sufficient non-cash deductions (e.g., CCA) to produce a nil Taxable Income.

**Taxable Allowance** An allowance provided by an employer to an Employee that must be included in the Employee's Employment Income. The amount is included on the Employee's T4.

**Taxable Benefit** An amount of money, or the value of goods or services, that an employer pays or provides in addition to Salary.

**Taxable Canadian Corporation** A Canadian Corporation that is not exempt from Canadian income tax by way of a statutory provision.

**Taxable Canadian Property** A group of assets that are listed under the definition of Taxable Canadian Property in ITA 248(1). These assets are distinguished by the fact that gains on their Disposition are taxable without regard to the residence of the selling Taxpayer. For example, if a U.S. Resident sells Canadian real estate, Canadian income tax will be assessed on any gain resulting from the sale.

**Taxable Capital Employed In Canada** This amount is the GAAP-determined capital of the Corporation, less the allowance for investments in other Corporations, multiplied by the percentage of the Corporation's activity at Permanent Establishments in Canada as determined under ITR 402. It is used in a number of calculations, including the determination of a small CCPC and the calculation of the reduction of the Small Business Deduction.

**Taxable Capital Gain** The taxable portion (currently one-half) of a Capital Gain.

**Taxable Entity** A defined organization or Individual that is subject to tax (e.g., Corporations are taxable entities for income tax purposes).

**Taxable Income** Net Income For Tax Purposes, less certain deductions that are largely specified in Division C of Part I of the *Income Tax Act*. These deductions include loss carry overs, the Lifetime Capital Gains Deduction, and for Corporations, Dividends and Charitable Gifts.

**Taxable Surplus** A surplus account that tracks certain sources of Income of a Foreign Affiliate.

**Taxation Year** The period that is covered by a Taxpayer's return. As defined in ITA 249, it is equal to a calendar year for Individuals and Inter Vivos Trusts, and a Fiscal Period for Corporations and Testamentary Trusts.

**Taxpayer** An entity that is required to file a tax return and pay taxes. For income tax purposes, a Taxpayer is an Individual, a Corporation, or a Trust.

**Taxpayer Relief Provisions** Information Circular 07-01 contains guidelines on the discretionary authority the Minister has to grant relief based on a Taxpayer's situation. An example would be a waiver of late filing interest and penalties because the Individual suffered a serious illness. It replaces the fairness provisions.

**Teacher And Early Childhood Educator School Supply Tax Credit** A refundable tax credit available to eligible educators for up to $1,000 of eligible expenditures.

**Tenancy In Common** A holding of property, either real or personal, by two or more Persons, with each having a divisible interest that can be sold.

**Term Preferred Shares** Preferred Shares which have a provision which allows them to be redeemed by the issuer or redeemed at the request of the holder.

**Terminal Loss** A deduction in the calculation of Business and Property Income which arises when the last asset in a CCA Class is retired and a positive balance is left in the Class.

**Testamentary Trust** A Trust that arises on, and as a consequence of, the death of an Individual.

**Thin Capitalization** A reference to situations where a non-resident Specified Shareholder is receiving interest on an amount of debt that exceeds two times the sum of his share of contributed capital plus 100% of Retained Earnings.

**Tie-Breaker Rules** Provisions in International Tax Treaties that are designed to prevent the Double Taxation of Dual Residents.

**TOSI** An acronym for Tax On Split Income. (See Split Income definition.)

**Transaction Tax** A tax that is assessed on specified types of transactions. Such taxes are most commonly applied to transactions involving the sale of goods or services.

**Transfer** To convey or move from one Taxpayer to a different Taxpayer.

**Transfer Pricing** An expression used to describe the price at which services, tangible property, and intangible property are traded across international borders between related or non-arm's length parties.

**Transfer Tax** A tax on the Transfer of property from one owner to another.

**Transferee** A Taxpayer to whom a Transfer is made.

**Transferor** A Taxpayer who makes a Transfer.

**Trust** A relationship in which one Person holds the title to property for the benefit of another Person.

**Trustee** An Individual or trust institution that holds legal title to property in trust for the benefit of the Trust Beneficiaries.

**Tuition Fees Tax Credit** A credit against Tax Payable that is available to Individuals making qualifying tuition payments. The base includes specified ancillary fees and fees and ancillary costs associated with writing university examinations and required examinations in professional programs.

**Twenty-One (21) Year Deemed Disposition Rule** A requirement, applicable to some types of Personal Trusts, that requires a deemed disposition of the Trust's capital property at the end of every twenty-one years.

## U

**Undepreciated Capital Cost (UCC)** The Capital Cost of a depreciable asset class, less the cumulative CCA that has been taken to date. The tax equivalent of net book value in accounting.

**Under Integration** An application of integration procedures (e.g., gross up and dividend tax credit rates) that results in a situation where income flowed through a corporation is subject to more tax payable than the same income received directly by an individual.

**Unused RRSP Deduction Room** The cumulative total of all RRSP Deduction Limits, less amounts deducted in those years. The end of the preceding year balance is used when calculating the RRSP Deduction Limit.

## V

**Valuation Day (V-Day)** December 22, 1971 for publicly traded assets and December 31, 1971 for other assets.

**Value Added Tax (VAT)** A tax based on the value added to a product at each stage of production or distribution by a particular entity. It is generally based on some accounting measurement of Income.

**Vertical Amalgamation** An Amalgamation of a Parent Company and one or more of its Subsidiaries.

**Vested Benefit** A benefit is vested if the beneficiary has an irrevocable right to receive it.

**Vested Contribution** A contribution is vested if the Individual making the contribution has an irrevocable right to either the amount of the contribution or a benefit of equivalent value.

**Volunteer Firefighters Tax Credit** A credit against Tax Payable that is available to volunteer firefighters who perform at least 200 hours of volunteer firefighting services during a taxation year.

**Volunteer Search And Rescue Workers Tax Credit** A credit against Tax Payable that is available to volunteer search and rescue workers who perform at least 200 hours of volunteer search and rescue services during a taxation year.

## W - Z

**Wholly Dependent Person** A Dependant who lives with the Taxpayer (this requirement is not applicable if the Dependant is the Taxpayer's child) in a self-contained domestic establishment and is eligible for the Eligible Dependant Tax Credit.

**Will** A document that is a legal declaration of an Individual's wishes as to the Disposition of his or her property after death.

**Winding-Up Of A 90% Owned Subsidiary** A Rollover provision that allows the asset of a 90% or more owned Subsidiary to be combined with the assets of its Parent Company, without tax consequences.

**Winding-Up Of A Canadian Corporation** A series of transactions that result in substantially all of the assets of a Canadian Corporation being distributed to the shareholders of that Corporation.

**Zero Emission Vehicles** A motor vehicle that is fully powered by electricity or hydrogen, or partially powered by electricity with a minimum battery capacity of 15 kwh.

**Zero-Rated Goods And Services** Goods and services that are taxable at a zero GST rate. The fact that they are designated as "taxable" means that Registrants who sell such goods and services are eligible for Input Tax Credits for the GST that they pay. Examples include basic groceries (e.g., milk, bread, and vegetables), prescription drugs, and exports.

# Notes